UNRELATED BUSINESS INCOME TAX

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JUNE 22, 25, 26, 29, AND 30, 1987

Part 3 of 3

JUNE 30, 1987; RECORD

Serial 100-28

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
80-518 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
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CONTENTS

Page

Press releases announcing the hearings 2

WITNESSES

U.S. Department of the Treasury, O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy) 11
Internal Revenue Service, Hon. Lawrence B. Gibbs, Commissioner of Internal Revenue, and Robert I. Brauer, Assistant Commissioner for Employee Plans and Exempt Organizations 61
U.S. Small Business Administration, Frank S. Swain, Chief Counsel for Advocacy 89
U.S. General Accounting Office, Jennie S. Stathis, Associate Director, General Government Division 129

Alabama State Lodge, Fraternal Order of Police, Horace W. Hodges 1687
Alabama Symphony Orchestra, Edward Wolff 1146
Allen, Robert L., Consortium of University Film Centers 508
Alpha Therapeutic Corp., H. Edward Matveld and Edward A. Colton 1069
Altman, Steven, Texas A&I University, on behalf of American Association of State Colleges and Universities 396
Amador Corp., James Wm. Johnson 533
American Arts Alliance, William P. Blair, C. William Stewart, Edward Purrington, and Edward Wolff 1146
American Association of Museums, Willard Boyd, Mary Schmidt Campbell, Robert J. McQuarie, and Beverly Barsook 1109
American Association of Retired Persons, Cyril F. Brickfield 1620
American Association of State Colleges and Universities, Steven Altman 396
American Bar Association, Section of Taxation, John B. Jones, Jr 1737
American Bus Association, Susan Perry 640
American Clinical Laboratory Association, Harry Groome 818
American Council for the Arts, Laura Lee Blanton 1124
American Council of Independent Laboratories, Grover C. Williams 551
American Council on Education (and 18 other higher education associations), John DiBiaggio 359
American Healthcare Institute, Merlin K. DuVal, M.D 927
American Heart Association, Thom R. Winkler 1026
American Hospital Association, Jack W. Owen and John D. Leech 919
American Institute of Certified Public Accountants, Federal Taxation Executive Committee, Herbert J. Lerner 1749
American Red Cross, Lewellys F. Barker, M.D 1066
American Society of Association Executives, Roderick L. Geer 1633
American Society of Travel Agents, Inc., Earlene L. Causey 606
American Speech-Language-Hearing Association, Patricia R. Cole 1306
American Veterinary Medical Association, Alton F. Hopkins and Harold Knirk 741
Arena Stage, C. William Stewart 1146
Asher, Thomas M., HemaCare Corp 1082
Ashley, James W., YMCA of the USA 1189
Association of Governing Boards of Universities and Colleges, A.J. Pfister 1012
Association of Business Publishers, Stephen Feldman 1357
Association of Telemessaging Services International, Inc., Mark J. Golden 879
Association of the Bar of the City of New York, Committee on Nonprofit Organizations, Carolyn C. Clark 1756

Page
Association of Washington Business, Gerald R. Brong 523
Austin Center for Speech-Language-Learning Disorders, Patricia R. Cole 1306
Barker, Lewellys F., M.D., American Red Cross 1066
Barrett, Pat, United Way of America 1017
Barsook, Beverly, Museum Store Association, and American Association of Museums 1109
Beck, J. Edward, Jr., National Easter Seal Society 1034
Bennett, James T., George Mason University 1796
Berno, Donald C., United States Chamber of Commerce 327
Betts, Richard, YMCAs of Philadelphia, and YMCA of the USA 1195
Blair, William P., American Arts Alliance 1146
Blanton, Laura Lee, American Council for the Arts 1124
Boyd, Willard, Field Museum of Natural History, and American Association of Museums 1109
Brickfield, Cyril F., American Association of Retired Persons 1620
Brong, Gerald R., Association of Washington Business; and International Communications Industries Association 523
Bruce, Robert J., Widener University, on behalf of National Association of Independent Colleges and Universities 411
Business Coalition for Fair Competition, Joseph F. O'Neil, John Satagay, and Kenton Paddy 212
California Business Coalition, Alice Gallagher Reed 1394
Campbell, Mary Schmidt, Studio Museum in Harlem, and American Association of Museums 1109
Carlton, Donald M., Radian Corp., and Professional Services Council 581
Carr, Jeff, Vanderbilt University 416
Cascade Athletic Club, Frank Eisenzimmer 1219
Catholic Health Association, Sister Bernice Coreil 906
Causey, Earlene L., American Society of Travel Agents, Inc 606
Clark, Carolyn C., Committee on Nonprofit Organizations, Association of the Bar of the City of New York 1756
Cohen, Sheldon S., National Assembly of National Voluntary Health & Social Welfare Organizations 232
Cole, Patricia R., Austin Center for Speech-Language-Learning Disorders, and American Speech-Language-Hearing Association 1306
Colton, Edward A., Alpha Therapeutic Corp 1069
Consortium of University Film Centers, Robert L. Allen 508
Coreil, Sister Bernice, Catholic Health Association 906
Council on Research and Technology, Joseph A. Saloom 499
Cousins, Solon B., YMCA of the USA 1172
Crowson, James L., University of Texas System 1699
Cummings, Robert S., Massachusetts Society for the Prevention of Cruelty to Animals 735
Dale, Harvey P., New York University School of Law 1857
DiBiaggio, John, National Association of State Universities and Land-Grant Colleges, on behalf of the American Council on Education (and 18 other higher education associations) 359
Ducate, Douglas L., Society of Petroleum Engineers, and National Association of Exposition Managers 1712
DuVal, Merlin K., M.D., American Healthcare Institute 927
Eisenzimmer, Frank, Cascade Athletic Club, on behalf of the International Racquet Sports Association 1219
Family Service America, Geneva B. Johnson and Patricia A. Langley 1041
Feldman, Stephen, Association of Business Publishers 1357
Fellman, Steven J., Textile Rental Services Association of America, on behalf of Gerald S. Ostrow 823
Field Museum of Natural History, Willard Boyd 1109
Fiscal Planning Services, Stuart I. Rabinowitz 1329
Fraternal Order of Police, Illinois State Troopers Lodge No. 41, David Lumerman 1670
Fraternal Order of Police, State Lodge of Alabama, Horace W. Hodges 1687
Fremont-Smith, Marion R., Independent Sector 153
Gambardella, Frank, National Association of Portable X-Ray Providers 1335
Garber, Charles A., Structure Probe, Inc 1318
Garrett, Spencer, Pierpoint Racquet Club, on behalf of the International Racquet Sports Association 1250
Geer, Roderick L., Million Dollar Round Table, and American Society of Association Executives 1633

Page
Golden Mark J., Association of Telemessaging Services International, Inc 879
Gray, Bradford H., Institute of Medicine, National Academy of Sciences 995
Groome, Harry, American Clinical Laboratory Association 818
Grosvenor, Gilbert M., National Geographic Society 1609
Guenther, George C., Talmage Tours, Inc., and National Tour Association, Inc. 622
Hager, Susan, United Way of New York State, and United Way of America 1017
Hansmann, Henry, Yale Law School 1832
Hasson, James K., Jr., Sutherland, Asbill & Brennan, and Emory University 1816
Health Industry Distributors Association, Paul B. Simmons and Robert H. Wilbur 809
HemaCare Corp., Thomas M. Asher 1082
Hess, Earl H., United States Chamber of Commerce 327
Hodges, Horace W., Fraternal Order of Police, State Lodge of Alabama 1687
Holm, Robin, National Hearing Aid Society 793
Hopkins, Alton F., American Veterinary Medical Association 741
Howe, Jonathan T., National School Boards Association 1293
Hoyt, John A., Humane Society of the United States 745
Hughes, Kingdon R., Subsurface Library 1327
Humane Society of the United States, John A. Hoyt 745
Hutton, William T., Hastings College of the Law, University of California 730
Illinois State Troopers Lodge No. 41, Fraternal Order of Police, David Lumerman 1670
Independent Sector, Marion R. Fremont-Smith 153
Inman, Thomas E., II, Virginia Home Medical 866
International Communications Industries Association, Gerald R. Brong 523
International Racquet Sports Association:
    John McCarthy 1205
    Frank Eisenzimmer 1219
    Spencer Garrett 1250
International Taxicab Association, Jerilyn Nettnin 872
Johnson, Geneva B., Family Service America 1041
Johnson, James Wm., Amador Corp 533
Jones, John B., Jr., American Bar Association, Section of Taxation 1737
Jones, Linda Wolf, Nonprofit Coordinating Committee of New York 316
Jones, Ray, Texas Hearing Aid Association 1303
Kertz, Consuelo Lauda, Business School, Emory University 723
Knirk, Harold, American Veterinary Medical Association 741
Langley, Patricia A., Family Service America 1041
Leech, John D., American Hospital Association 919
Lehrfeld, William J., Shriners Hospitals for Crippled Children 935
Lerner, Herbert J., Federal Taxation Executive Committee, American Institute of Certified Public Accountants 1749
Littleton History Museum, Robert J. McQuarie 1109
Lumerman, David, Fraternal Order of Police, Illinois State Troopers Lodge No. 41 1670
Mason, Thomas, Notre Dame University, on behalf of National Association of College and University Business Officers 403
Massachusetts Society for the Prevention of Cruelty to Animals, Robert S. Cummings 735
Matveld, H. Edward, Alpha Therapeutic Corp 1069
Mayer, Robert, National Association of Small Business Against Hospital Unfair Competition 864
McCarthy, John, International Racquet Sports Association 1205
McQuarie, Robert J., Littleton History Museum, and American Association of Museums 1109
Michigan Humane Society, David K. Wills 753
Million Dollar Round Table, Roderick L. Geer 1633
Montrose Animal Health Center, Nolan P. Rubin 751
Motley, John J., III, National Federation of Independent Business 270
Museum Store Association, Beverly Barsook 1109
National Academy of Sciences, Institute of Medicine, Bradford H. Gray 995
National Assembly of National Voluntary Health & Social Welfare Organizations, Sheldon S. Cohen and W. Harrison Wellford 232
National Association of College and University Business Officers, Thomas Mason 403
National Association of Exposition Managers, Douglas L. Ducate 1712

Page
National Association of Independent Colleges and Universities, Robert J. Bruce 411
National Association of Portable X-Ray Providers, Frank Gambardella 1335
National Association of Regional Media Centers, Mark L. Richie 513
National Association of Small Business Against Hospital Unfair Competition, Robert Mayer 864
National Association of State Universities and Land-Grant Colleges, John DiBiaggio 359
National Easter Seal Society, J. Edward Beck, Jr 1034
National Federation of Independent Business, John J. Motley III and Abraham Schneier 270
National Geographic Society, Gilbert M. Grosvenor 1609
National Hearing Aid Society, Robin Holm 793
National School Boards Association, Jonathan T. Howe 1293
National Tour Association, Inc., George C. Guenther 622
Nettin, Jerilyn, International Taxicab Association 872
Nonprofit Coordinating Committee of New York, Peter Swords and Linda Wolf Jones 316
Notre Dame University, Thomas Mason 403
O'Neil, Joseph F., Business Coalition for Fair Competition 212
Ostrow, Gerald S. (*See* Textile Rental Services Association of America.)
Owen, Jack W., American Hospital Association 919
Paddy, Kenton, Business Coalition for Fair Competition 212
Perry, Susan, American Bus Association 640
Peterson, Eric C., United Bus Owners of America 634
Pfister, A.J., Association of Governing Boards of Universities and Colleges 1012
Pierpoint Racquet Club, Spencer Garrett 1250
Professional Services Council, Donald M. Carlton 581
Purrington, Edward, Washington Opera, and American Arts Alliance 1146
Rabinowitz, Stuart I., Fiscal Planning Services 1329
Radian Corp., Donald M. Carlton 581
Reed, Alice Gallagher, California Business Coalition 1394
Richie, Mark L., National Association of Regional Media Centers 513
Rose-Ackerman, Susan, Columbia University 1830
Rubin, Nolan P., Montrose Animal Health Center 751
Rudney, Gabriel, Institution for Social and Policy Studies, Yale University 985
Saloom, Joseph A., Council on Research and Technology 499
Sanford, Hon. Terry, a U.S. Senator from the State of North Carolina 353
Satagaj, John S., Small Business Legislative Council 1348
Satagay, John, Business Coalition for Fair Competition 212
Schneier, Abraham, National Federation of Independent Business 270
Seay, J. David, United Hospital Fund of New York 951
Shillingburg, J. Edward, Lord, Day & Lord 1845
Shriners Hospitals for Crippled Children, William J. Lehrfeld 935
Simmons, Paul B., Health Industry Distributors Association 809
Small Business Legislative Council, John S. Satagaj 1348
Society of Petroleum Engineers, Douglas L. Ducate 1712
Stark, Hon. Fortney H. (Pete), a Representative in Congress from the State of California 766
Stewart, C. William, Arena Stage, and American Arts Alliance 1146
Structure Probe, Inc., Charles A. Garber 1318
Studio Museum in Harlem, Mary Schmidt Campbell 1109
Subsurface Library, Kingdon R. Hughes 1327
Swords, Peter, Nonprofit Coordinating Committee of New York 316
Talmage Tours, Inc., George C. Guenther 622
Texas A&I University, Steven Altman 396
Texas Hearing Aid Association, Ray Jones 1303
Textile Rental Services Association of America, Steven J. Fellman on behalf of Gerald S. Ostrow 823
Trinity Engineering Testing Corp., Grover C. Williams 551
United Bus Owners of America, Eric C. Peterson 634
United Hospital Fund of New York, J. David Seay 951
United States Chamber of Commerce, Earl H. Hess and Donald C. Berno 327
United Way of America, Susan Hager and Pat Barrett 1017
United Way of New York State, Susan Hager 1017
University of Texas System, James L. Crowson 1699
Vanderbilt University, Jeff Carr 416
Virginia Home Medical, Thomas E. Inman II 866

Page
Washington Opera, Edward Purrington 1146
Webster, George D. Webster, Chamberlain, Bean & McKevitt 1801
Wellford, W. Harrison, National Assembly of National Voluntary Health & Social Welfare Organizations 212
Widener University, Robert J. Bruce 411
Wilbur, Robert H., Health Industry Distributors Association 809
Williams, Grover C., Trinity Engineering Testing Corp., and American Council of Independent Laboratories 551
Wills, David K., Michigan Humane Society 753
Winkler, Thom R., American Heart Association 1026
Wolff, Edward, Alabama Symphony Orchestra, and American Arts Alliance 1146
YMCA of the USA:
  Solon B. Cousins 1172
  James W. Ashley 1189
  Richard Betts 1195
YMCAs of Philadelphia, Richard Betts 1195

SUBMISSIONS FOR THE RECORD

ADAPSO, George T. DeBakey, statement 1880
Airport Limousine Service Inc., James L. Sunstein, letter 1882
Allen, William E., D.D.S., American Dental Association, letter 1886
American Bankers Association, statement 1883
American Collectors Association, John W. Johnson, statement 1638
American Dental Association, William E. Allen, D.D.S., letter 1886
American Diabetes Association, Inc., statement 1895
American Legion, Robert W. Spanogle, statement and attachments 1901
American Medical Association, statement 1917
American Society for Personnel Administration, statement 1922
American Society of Association Executives, John W. Johnson, statement 1638
Andrews, Martha A., Businesses and Associations for a Strong Economy, letter and attachments 1968
Applied Research Associates, Paul O. Davis, letter 1926
Arizona Hearing Aid Society, K. Ray Katz, letter and attachment 1928
Aronofsky, David J., Earl W. Kintner, Michael D. Barnes, and Marc L. Fleischaker, National Association of College Stores, joint letter 2222
Audio Hearing Aid Center, Inc., Lawrence J. House, letter 1931
Audio Prosthetics, Samuel I. Kiser, letter 1932
Audiologic Services, Albert P. Silverio, letter 1933
Bakalars, Edward J., La Crosse Hearing Aid Center, letter 2198
Bankers Committee for Tax Equality, statement 1934
Barnes, Michael D., Earl W. Kintner, Marc L. Fleischaker, and David J. Aronofsky, National Association of College Stores, joint letter 2222
Bartolucci, John, Beltone Hearing Aid Service, Springfield, Mass., letter 1953
Beltone Hearing Aid Center:
  Ervin E. King, Billings, Montana, letter and attachment 1940
  Karen S. Maas, Traverse City, Michigan, letter and attachments 1942
  Eules T. Morgan, Florence, S.C., letter 1949
  James Ogurek, Ogurek Enterprises, Inc., Wausau, Wisconsin, letter 1950
Beltone Hearing Aid Service:
  John Bartolucci, Springfield, Mass., letter 1953
  James A. Bohren, Sheboygan, Wisconsin, letter and attachments 1956
  William E. King, Pittsburgh, Pa., letter and attachment 1963
  Richard Pitt, Statesboro, Georgia, letter 1965
  Curt Wallis, Peggy Wallis, J. Michael Wallis, Josh Villasenor, and Karen W. Villasenor, Odessa, Texas, joint letter 1966
Bethlehem Hearing Aid Center, Thomas R. Stephens, letter 1967
Boehlert, Hon. Sherwood, a Representative in Congress from the State of New York, and Hon. Bob Wise, a Representative in Congress from the State of West Virginia, joint letters 2356
Bohren, James A., Beltone Hearing Aid Service, Sheboygan, Wisconsin, letter and attachments 1956
Bollinger, Terry, Mid-Kansas Acousticon, Inc., letter 2220
Businesses and Associations for a Strong Economy, Martha A. Andrews, letter and attachments 1968

Page
Cappabianca, Hon. Italo S., Select Committee to Study Business Activities of Nonprofits, Pennsylvania House of Representatives, statement and attachment 1726
Carter, Rev. James C., Loyola University, statement 2200
Catholic Charities USA, statement 2145
Christensen, Elfreda, Elfreda Christensen Hearing Aids, letter 2152
Cook-Witter, Inc., Randall F. Witter, letter 2153
Councilman, Dorothy, Hearing Aid Center, letter and attachments 2177
Davis, Paul O., Applied Research Associates, letter 1926
DeBakey, George T., ADAPSO, statement 1880
Dewey, Ballantine, Bushby, Palmer & Wood, statement 2154
Drake Hearing Aid Center, Timothy L. Drake, letter 2158
Eaneman, Robert G., Volunteer Trustees of Not-For-Profit Hospitals, statement 2353
Edwards, Wade H., Florida Hospital Association, Inc., letter 2163
Erie Audiology & Hearing Aid Center, Neal E. Mann, letter 2161
Evans, Sam, YMCA, National Board, statement 1202
Fishman, Joseph D., New Jersey Guild of Hearing Aid Dispensers, letter 2288
Fleischaker, Marc L., Earl W. Kintner, Michael D. Barnes, and David J Aronofsky, National Association of College Stores, joint letter 2222
Florida Chiropractic Association, Inc., Ed Williams, letter 2162
Florida Hospital Association, Inc., Wade H. Edwards, letter 2163
Galles, John Paul, National Small Business United, statement 2284
Gillum, Charlie, Charlie Gillum United Hearing Aid Service, letter 2164
Goodwill Industries of America, Inc., statement 2165
Greene, Cary W., Hearing Aid Specialists, letter 2181
Hackett, Stanley H., Jebco, Inc., letter 2188
Hammond, Dean, Hammond, Inc., on behalf of U.S. Cartographic Industry Members, statement and attachments 2345
Haspel Donald P., National Office Products Association, statement 2282
Haviland Hearing Aids, Richard H. Haviland, letter 2175
Healthcare Financial Managment Association, statement 2182
Hearing Aid Associates, William J. and Dolores P. Kemple, joint letter 2176
Hearing Aid Center, Dorothy Councilman, letter and attachments 2177
Hearing Aid Specialists, Cary W. Greene, letter 2181
Hieb, Carol J., Statewide Hearing Aid Center, letter and attachments 2328
Hospital Trustees of New York State, statement 2185
House, Lawrence J., Audio Hearing Aid Center, Inc., letter 1931
Jebco, Inc., Stanley H. Hackett, letter 2188
Johnson, John W., American Collectors Association, and American Society of Association Executives, statement 1638
Katz Hearing Aid Center, Kalman R. Katz, statement and attachment 2191
Katz, K. Ray, Arizona Hearing Aid Society, letter and attachment 1928
Kemple, William J., and Dolores P., Hearing Aid Associates, joint letter 2176
Kerr, Jeannette, MAICO Hearing Aid Service, letter 2209
King, Ervin E., Beltone Hearing Aid Center, Billings, Montana, letter and attachment 1940
King, William E., Beltone Hearing Aid Service, Pittsburgh, Pa., letter and attachment 1963
Kintner, Earl W., Michael D. Barnes, Marc L. Fleischaker, and David J. Aronofsky, National Association of College Stores, joint letter 2222
Kiser, Samuel I., Audio Prosthetics, letter 1932
La Crosse Hearing Aid Center, Edward J. Bakalars, letter 2198
Lake, F. David, Jr., University Patents, Inc., statement 2342
Lifset, Reid J., Department of Political Science, Massachusetts Institute of Technology, statement and attachment 2210
Loyola University, Rev. James C. Carter, statement 2200
Maas, Karen S., Beltone Hearing Aid Center, Traverse City, Michigan, letter and attachments 1942
MAICO Hearing Aid Service, Jeannette Kerr, letter 2209
Mann, Neal E., Erie Audiology & Hearing Aid Center, letter 2161
Mattox, Hon. Jim, Attorney General, State of Texas, letter 2336
Mertz, George J., National Industries for the Blind, statement 2272
Mid-Kansas Acousticon, Inc., Terry Bollinger, letter 2220
Miller, C.L. "Kip", and Elizabeth "Betty", Orange Hearing Aids, joint letter 2298
Morgan, Eules T., Beltone Hearing Aid Center, Florence, S.C., letter 1949
Murphy, Robert, Statewide Hearing Aid Center, letter and attachments 2334

Page
National Association of College Stores, Earl W. Kintner, Michael D. Barnes, Marc L. Fleischaker, and David J. Aronofsky, joint letter 2222
National Association of Home Builders, statement 2238
National Association of Retail Druggists, John M. Rector, letter and attachments 2241
National Industries for the Blind, George J. Mertz, statement 2272
National Office Products Association, Donald P. Haspel, statement 2282
National Small Business United, John Paul Galles, statement 2284
National Society of Professional Engineers, Donald G. Weinert, letter 2286
New Jersey Guild of Hearing Aid Dispensers, Joseph D. Fishman, letter 2288
Novak Hearing Center, Charles J. Novak, letter 2291
Ogurek, James, Ogurek Enterprises, Inc., Beltone Hearing Aid Center, Wausau, Wisconsin, letter 1950
Oliver, Daniel, Federal Trade Commission, statement 2293
Orange Hearing Aids, C. L. "Kip" and Elizabeth "Betty" Miller, joint letter 2298
Pitt, Richard, Beltone Hearing Aid Service, Statesboro, Georgia, letter 1965
Pennsylvania House of Representatives, Select Committee to Study Business Activities of Nonprofits, Hon. Italo S. Cappabianca, statement and attachment 1726
Powell, R. K., Silver Spring, Maryland, letter 2299
Rector, John M., National Association of Retail Druggists, letter and attachments 2241
Schauer Hearing Aid Center's of North Dakota, Floyd Schauer, et al, joint letter and attachments 2305
Silverio, Albert P., Audiologic Services, letter 1933
Society of National Association Publications, statement 2316
Society of the New York Hospital, statement 2318
Spanogle, Robert W., American Legion, statement and attachments 1901
Statewide Hearing Aid Center, Great Falls, Montana:
  Carol J. Hieb, letter and attachments 2328
  Robert Murphy, letter and attachments 2334
Stephens, Thomas R., Bethlehem Hearing Aid Center, letter 1967
Sunstein, James L., Airport Limousine Service Inc., letter 1882
Texas, State of, Hon. Jim Mattox, Attorney General, letter 2336
U.S. Cartographic Industry Members, Dean Hammond, Hammond, Inc., statement and attachments 2345
University Patents, Inc., F. David Lake, Jr., statement 2342
Villasenor, Josh and Karen W., Beltone Hearing Aid Service, Odessa, Texas, joint letter 1966
Volunteer Trustees of Not-For-Profit Hospitals, Robert G. Eaneman, statement 2353
Wallis, Curt, J. Michael, and Peggy, Beltone Hearing Aid Service, Odessa, Texas, joint letter 1966
Weinert, Donald G., National Society of Professional Engineers, letter 2286
Williams, Ed, Florida Chiropractic Association, Inc., letter 2162
Wise, Hon. Bob, a Representative in Congress for the State of West Virginia, and Hon. Sherwood Boehlert, a Representative in Congress from the State of New York, joint letters 2356
Witter, Randall F., Cook-Witter, Inc., letter 2153
Woodard Hearing Aid Centers, Paul E. Woodard, letter and attachment 2359
YMCA, National Board, Sam Evans, statement 1202
Young's Hearing Aid Service, G. Charles Young, letter 2361

UNRELATED BUSINESS INCOME TAX

TUESDAY, JUNE 30, 1987

House of Representatives,
Committee on Ways and Means,
Subcommittee on Oversight,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:06 a.m., in room B-318, Rayburn House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

Chairman Pickle. Good morning. We are glad to have you here. We are going to resume our subcommittee hearing.

Today we will hold our final day of subcommittee hearings to review the unrelated business income tax matter.

We have two panels of distinguished witnesses scheduled for today, and they represent professional tax practitioner organizations and individuals, academicians, and others actively involved in the analysis of unrelated business income tax.

We welcome you and we appreciate your appearing before the subcommittee. I am sure that each of you have seen a copy of the Treasury's recommendations or suggestions for possible corrections in this field, and we would like to have your comments on those suggestions or to have other suggestions you might have, because this may be the last day of public hearings we will have before we consider the approach that this subcommittee may take on the overall issue.

So we appreciate you coming. Now, we take it you individuals are probably more seasoned and more experienced in this field as practitioners than many of the people who represented individual organizations or individuals businesses. So what you can pass on to us and relay to us would be of importance. We thank you for your participation and your appearance and for your testimony today.

Mr. Schulze, have you got any statement you want to make?

Mr. Schulze. Thank you, Mr. Chairman.

I am pleased to join you in our fifth and final day of hearings on the unrelated business activities of tax-exempt organizations.

After 4 days of intensive hearings, the evidence reveals that tax-exempt organizations are not always charitable toward small business. In some cases, the problem appears to arise when a tax-exempt organization expands a related activity a bit too far. This might involve the university bookstore which expands its product line to include computers and blue jeans; it might involve a nonprofit hospital which expands its laundry facility in order to bid on commercial cleaning contracts. In other cases, the unfair competition appears to arise from a nonprofit organization deliberately targeting the market of existing small businesses. This could involve university research departments bidding to perform private environmental and testing services, or involve the nonprofit hospital acting to corner the local market in durable medical equipment and hearing aids.

Whether the activity by the nonprofit organization is incidental or deliberate, the effect is still troublesome to small business. The balance, which the UBIT law sought to establish between nonprofit groups and for-profit businesses, appears to have been tilted to the advantage of some aggressive, nonprofit groups.

Mr. Chairman, our hearings have been useful in documenting these activities and in helping to provide a foundation for corrective action. Today's expert witnesses will round out our hearings. They can pull together the testimony of the past 4 days and help us develop a comprehensive assessment of the problem.

After we develop a comprehensive assessment of the problem, we will be in a position to develop a responsible solution.

Mr. Chairman, I thank all the witnesses for their participation over the last 4 days, and I join you in welcoming today's witnesses and look forward to their testimony.

Chairman PICKLE. Our first panel, and I might add that this panel is invited witnesses—we have asked you to come and give us the benefit of your experience or involvement in the issue. The first panel consists of John B. Jones, chairman of the American Bar Association, Section of Taxation. Mr. Jones.

Then we have Herbert Lerner, who is a CPA, chairman of the executive committee of the American Institute of Certified Public Accountants. Mr. Lerner.

Then we have Carolyn C. Clark, who is chair, Committee on Nonprofit Organizations, representing the Association of the Bar of New York City. Ms. Clark.

Then we have Italo Cappabianca—is he the gentleman who is not here today, who had to cancel?

His statement will be made a part of the record.

[The statement of Mr. Cappabianca and subsequent submissions to the subcommittee follow:]

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House of Representatives
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#1

TO THE HONORABLE J. J. PICKLE, CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

REMARKS
BY

ITALO S. CAPPABIANCA, CHAIRMAN
SELECT COMMITTEE TO STUDY BUSINESS ACTIVITIES OF NONPROFITS
PENNSYLVANIA HOUSE OF REPRESENTATIVES
JUNE 30, 1987

TO THE HONORABLE CHAIRMAN AND MEMBERS OF THIS DISTINCT COMMITTEE:

THE ISSUE OF UNFAIR OR DIRECT BUSINESS COMPETITION FROM NONPROFITS IS A COMPLEX AND DIVERSE ISSUE, OPEN FOR MANY DISCUSSIONS BOTH FROM A PHILOSOPHICAL AND PRAGMATIC POINT OF VIEW.

HOWEVER, THERE IS CLEAR EVIDENCE THAT UNFAIR OR DIRECT BUSINESS COMPETITION DOES EXIST IN THE COMMERCIAL BUSINESS MARKETPLACE FROM NONPROFITS.

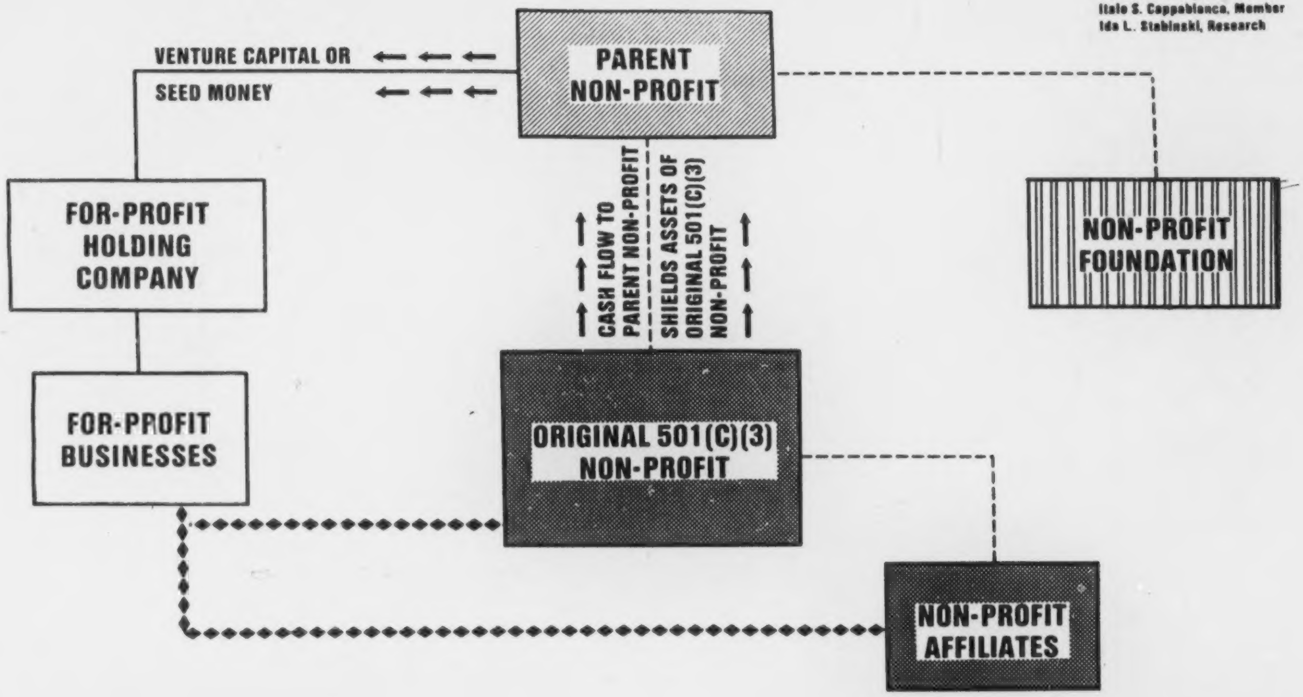
THIS EVIDENCE IS MOST BLATANT WITHIN THE CORPORATE RESTRUCTURING OF A NONPROFIT ENTITY. IF A NONPROFIT ENTITY OPTS TO RESTRUCTURE AND CREATE A SEPARATE LEGAL ENTITY, KNOWN AS A PARENT NONPROFIT (501-C-3) HOLDING COMPANY, IT CAN SHIELD ITS ASSETS THROUGH THIS LEGAL ENTITY THEREBY BECOMING THE SUBSIDIARY OR AFFILIATE.

THEREAFTER, THE PARENT NONPROFIT HOLDING COMPANY CREATES STILL ANOTHER LEGAL FOR-PROFIT ENTITY. THE UNFAIR BUSINESS ADVANTAGE EXISTS WHEN TAX-EXEMPT MONIES OR SURPLUSES ARE USED AS SEED MONEY OR VENTURE CAPITAL TO CREATE THESE COMMERCIAL BUSINESSES IN THE CORPORATE RESTRUCTURING OF A NONPROFIT ENTITY.

MOREOVER, THE FOR-PROFIT ENTITY ENGAGES IN UNFAIR OR DIRECT BUSINESS PRACTICES WHEN IT CONTRACTS SERVICES, OR ENTERS INTO JOINT VENTURES WITH THE ORIGINAL TAX-EXEMPT ENTITY THAT CREATED THIS CORPORATE RESTRUCTURING. SUBSEQUENTLY, THE PRODUCTS OR SERVICES ARE MARKETED IN A TAX-EXEMPT ENVIRONMENT. ALL OF THE AFOREMENTIONED CONSTITUTE DIRECT AND UNFAIR BUSINESS PRACTICES. THESE SO CALLED BUSINESS VENTURES BECOME SWEETHEART CONTRACTS OR COULD BE CONSTRUED AS COMMERCIAL NEPOTISM BECAUSE EACH AND EVERY VENTURE WAS ESSENTIALLY ESTABLISHED BY THE ORIGINAL NONPROFIT, THROUGH ITS OWN VOLITION, BY THE CORPORATE RESTRUCTURING.

I WILL ATTEMPT TO GRAPHICALLY ILLUSTRATE THE CORPORATE RESTRUCTURING OF A NONPROFIT AND WOULD LIKE TO THANK YOU AT THIS TIME FOR ALL COURTESIES AFFORDED TO ME DURING MY PRESENTATION.

PA House of Representatives
Italo S. Cappabianca, Member
Ida L. Stabinski, Research


VENTURE CAPITAL OR
SEED MONEY
PARENT NON-PROFIT
NON-PROFIT FOUNDATION
FOR-PROFIT HOLDING COMPANY
CASH FLOW TO PARENT NON-PROFIT
SHIELDS ASSETS OF ORIGINAL 501(C)(3) NON-PROFIT
FOR-PROFIT BUSINESSES
ORIGINAL 501(C)(3) NON-PROFIT
NON-PROFIT AFFILIATES

▩	**ORIGINAL 501(C)(3) NON-PROFIT.** Given tax-exempt status at the time of its creation.
▨	**PARENT NON-PROFIT CORPORATION.** Probably created in early 1980s; original non-profit becomes a subsidiary.
‖‖‖‖‖‖	**NON-PROFIT FOUNDATION.** Also created by original non-profit; usually used as a fundraising arm.
☐	**FOR-PROFIT HOLDING COMPANY.** Creates and may manage profit-making businesses and management service firms.
▒	**FOR-PROFIT BUSINESSES.** Often strongly connected to original non-profit and its affiliates through leases, contracts, joint ventures, etc.
———	Transfer of investment, seed money, venture capital.
- - - - - - -	Cash flow between non-profit entities.
◆◆◆◆◆◆	Existence of joint ventures, contracts, leases, royalties, annuities, or like ventures, creates the possibility of inurement or unfair business competition by the original

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SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

REMARKS BY
ITALO S. CAPPABIANCA, CHAIRMAN
SELECT COMMITTEE TO STUDY BUSINESS ACTIVITIES OF NONPROFITS
PENNSYLVANIA HOUSE OF REPRESENTATIVES
JUNE 30, 1987

ISSUE

Can commercial for-profit entrepreneurs survive because of potential unfair or direct business competition from nonprofit entities?

OVERVIEW

The most common rationale offered for exempting nonprofits from taxation is that they provide an intangible service to the community. The public goods rationale suggests that nonprofits should be granted tax exemption for providing these charitable services that might otherwise have to be provided by the government.

When addressing the issue of unfair business competition from nonprofits, the sensitivity to the charitable service provided must be demonstrated. This sensitivity must be in terms of need of the charitable service offered as opposed to the nonprofit service in broad general terms. Therefore, a clear understanding of the nonprofit service becomes essential with regard to revenue programs generated by a nonprofit to fund the purpose for which it was created.

If there is a genuine community charitable need for a nonprofit service, then funding for the nonprofit service becomes tantamount. Both commercial for-profit entrepreneurs and nonprofit entities agree with this concept. However, it becomes readily evident that the differences and controversies are with regard to the sources and methods of revenue generating programs within the organizational structure of the nonprofit entity to fund its nonprofit status.

Moreover, nonprofits venture into revenue generating programs that are being performed by commercial for-profit enterprises who pay a host of federal, state, and local taxes for the opportunity to perform the identical business venture. There is most assuredly a nebulous area of when does direct or unfair business competition begin if, in fact, the nonprofit service must be funded by a revenue generating program to carry out the purpose for which the nonprofit was created. This area must be cautiously defined in order not to jeopardize the revenue generating programs of a genuine charitable nonprofit and at the same time not to further jeopardize the commercial for-profit businesses who could go-bankrupt or out-of-business because of direct or unfair business competition from the nonprofit sector.

Nonprofits should not be permitted to wear two hats---a nonprofit and a for-profit. A nonprofit operating within the scope of its purpose needs adequate funding to perform that service to the community. However, when a nonprofit ventures into profit making businesses, of their own volition, with nonprofit surpluses this becomes somewhat questionable. Surplus monies of a nonprofit that ventures into these for-profit businesses is venture capital thereby creating unfair competition to the for-profit business community. This is the most blatant abuse within any organizational structure of nonprofits that opts to create revenue generating programs. Moreover, the nonprofit has the advantage of testing the waters with feasibility and marketing studies before venturing into lucrative business contracts. This is another disadvantage to the commercial business community. If all commercial for-profit businesses had the luxury of instant venture capital, seed money, testing the waters with feasibility studies, and marketing of their products, in a tax-exempt nonprofit environment, as nonprofits currently entertain, we would have a flourishing economy within the commercial small business sector.

CONCERNS

Funding for nonprofits to generate revenue to perform the purpose for which they were created.

The use of tax-exempt nonprofit facilities to market a business venture that is in direct competition with for-profit enterprises that pay a host of federal, state and local taxes for the opportunity to do business.

Surplus or unrestricted funds that are used by nonprofits as venture capital or seed money which are transferred between family organizational entities with no accountability.

Nonprofits entering into commercial business ventures to fund their nonprofit status with no accountability.

Competitive bidding by nonprofits with commercial for-profit enterprises when the nonprofit owns the bidding for-profit entity and subsequently performs the marketable service in a nonprofit environment.

Contracting of services between all nonprofit and for-profit entities with no accountability.

Nonprofits that tie one service to another through "captive referral" between the nonprofit and a for-profit entity within the same family organizational structure and the contracting of services therein.

Closed board of director meetings when any of the aforementioned board decisions are made within the organizational structure of any parent or subsidiary nonprofit.

Board of directors serving on both nonprofit and for-profit entities within the same organizational family structure.

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September 4, 1987

Hon. J. J. Pickle, Chairman
Ways and Means Subcommittee on Health
U. S. House of Representatives
Room 242 - Cannon Building
Washington, D.C. 20515

Dear Congressman Pickle,

I have, respectfully, taken this opportunity to address the enclosures to your attention in the belief that they may relate to your Subcommittee's research activities.

My feeling in doing so stems from my awareness that the complaints we have been hearing from the for-profit sector, here in Pennsylvania, are echoed in other areas of the nation.

This belief stems from my awareness of conclusions noted at the White House Conference on Small Business last August. As you know, that Conference cited unfair competition from the non-profit sector as a major threat to the survival of the for-profit community.

I hope, then, that this mailing will prove of some use to your Committee, and that it may contribute to whatever corrective legislation may be needed in this area should the Postmaster-General advise that current rules do not preclude for-profit use of the non-profit mailing privilege.

Thank you for your attention to this matter.

Sincerely,

Italo S. Cappabianca, Chairman
Select Committee to Study Business
Activities of Nonprofits in Pennsylvania

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September 4, 1987

Albert V. Casey, Postmaster-General
475 L'enfant Plaza, S.W.
Washington, D. C. 20260-0010

Dear Postmaster-General Casey,

On behalf of our Select Committee to Study Business Activities of the Nonprofits in Pennsylvania, I'm asking your clarification on a serious question that has surfaced during our research hearings.

To that end, I'm enclosing here copies of pertinent documents. These include: a copy of the face of an envelope in which a clothing sales catalog was sent to me, on behalf of a for-profit affiliate of a non-profit encity; and copies of the front page of the catalog, itself, and a promotional letter accompanying same.

Our Committee determined that the for-profit promoter of that catalog, "Mothers Work," is an affiliate of the non-profit Magee-Womens Hospital of Pittsburgh. This was confirmed in testimony given our Committee by an officer of the Hospital, during public hearings held here in Erie on August 27 and August 28.

Please note that the envelope face bears the imprint of the Non-profit stamp permit issued to Magee Womens Hospital, as well as the return address of the Hospital, itself. Again, however, the material it conveyed promotes the Hospital's for-profit affiliate, Women's Work.

As Chairman of the aforementioned Committee, and as Chairman of the House's Special Subcommittee on Small Business, I have dual serious concerns about this matter. Additionally, of course, it is important that all of us on the Select Committee are able to respond correctly and definitively to the many complaints addressed to us by the for-profit community which tie to the use of the Non-profit mailing privilege by for-profit affiliates. The independent, for-profit sector regards this as an example of unfair competition.

Such usage of the permit may also be an infringement on postal laws and regulations. This, too, increases our anxiety for learning the facts about the matter.

With all of this in mind, then, I'm hoping that you will review this request and respond as expeditiously as possible. I will certainly be most appreciative.

Sincerely,

Italo S. Cappabianca, Chairman
Select Committee to Study Business Activities
of the Non-profits

MAGEE-WOMENS HOSPITAL
University Health Center of Pittsburgh
Forbes Avenue and Halket Street
Pittsburgh, Pennsylvania 15213

NON-PROFIT ORG.
U.S. Postage
PAID
Pittsburgh, Pa.
Permit No. 2190

Italo S. Cappabianca
1216 W. 26th St.
Erie, PA 16508

Mothers Work™
Pittsburgh

434 Seventh Avenue
Koppers Building
Pittsburgh, PA 15219

(412) 471-MOMS

Dear Mother-to-be,

The staff of Mothers Work Pittsburgh sends congratulations to you.

We know it has been difficult to find fashionable maternity clothing in Pittsburgh and that it can be tiresome, especially when you're pregnant, to travel from store to store to coordinate a new wardrobe. That's exactly why we opened Mothers Work: to cater to the working woman. In addition to the Mothers Work line, we will carry other exciting clothing--dresses, sportswear, lingerie, bathing suits--so you can maintain your sense of style while pregnant by shopping in just one place.

We understand the unique needs of the woman who buys maternity fashions, and we look forward to giving you the special attention you deserve.

Sincerely,

Goldie M. Samuels

Goldie M. Samuels
Manager
Mothers Work Pittsburgh

Mothers Work
Pittsburgh

Koppers Building/434 Seventh Avenue
Pittsburgh, PA 15219
(412) 471-MOMS

(Please print clearly)

Sold to:
Name ____________________
Address ____________________
City ____________ State ____ Zip____
Phone (during the day) ____________________

Ship to:
Name ____________________
Address ____________________
City ____________ State ____ Zip____
Phone (during the day) ____________________

Charge orders ($20 minimum)

Card No. ____________ Exp. date ____________ Please check card used: ☐ Master Card ☐ Visa
Issuing Bank ____________________ Signature ____________________

Mail-in Order Form

PAGE No.	STYLE No.	STYLE DESCRIPTION	SIZE	COLOR CHOICE	SECOND COLOR (If app.)	FABRIC No.	PRICE

NO CASH OR CODs PLEASE
Make Check or Money Order
Payable to:
Mothers Work Pittsburgh

Merchandise total	$
Shipping Chg.	3.00
Order total	

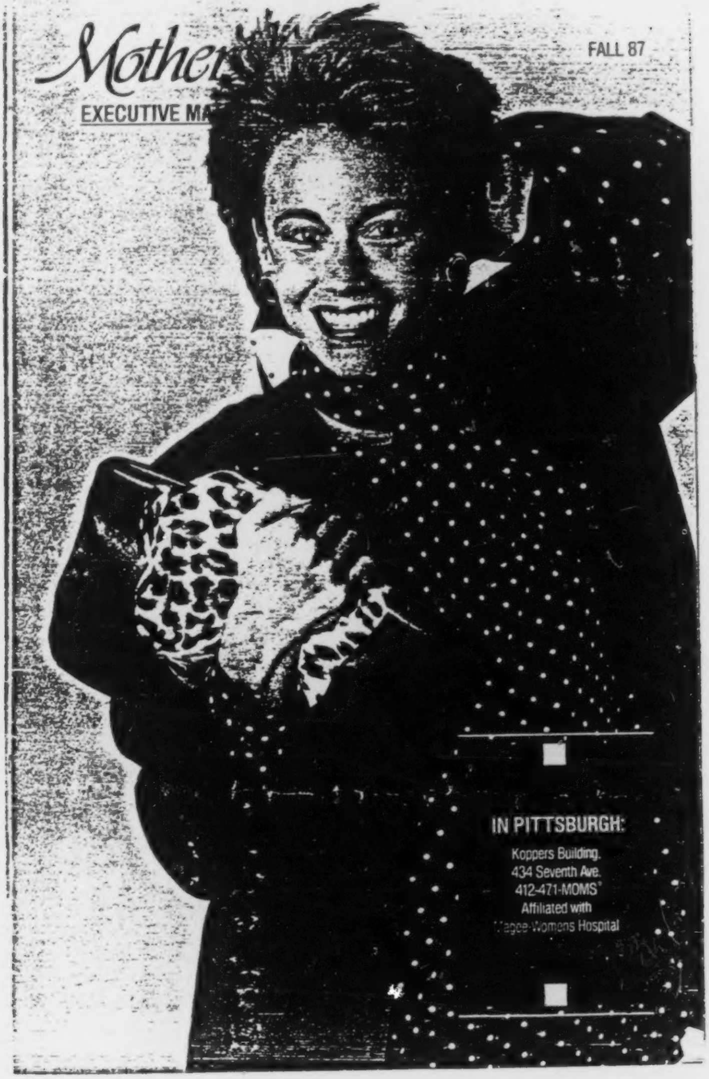
MOTHERS WORK PITTSBURGH

$10 GIFT

This certificate, worth $10.00, is our gift to you. Present it at our shop and receive $10.00 off a purchase of $50.00 or more. Limit one per customer. Please call for store operating hours. This gift may **not** be applied to a mail order.

434 Seventh Avenue ● Pittsburgh, PA 15219 ● (412) 471-MOMS

We look forward to seeing you!



Mother

FALL 87

EXECUTIVE MA

IN PITTSBURGH:

Koppers Building,
434 Seventh Ave.
412-471-MOMS
Affiliated with
Magee-Womens Hospital

Chairman **Pickle**. Then James T. Bennett, professor of political economy and public policy, Department of Economics, George Mason University. Mr. Bennett.

And then we have George D. Webster, Esq., representing Webster, Chamberlain, Bean & McKevitt, a well-known firm here in Washington. Mr. Webster.

This is a very distinguished panel so we are pleased to have each one of them. I am going to ask then that Mr. Jones proceed as our first witness. In the interest of time—we don't want to cut any of you off, and we don't want to have you limited—but we hope that each one of you can sort of summarize your position in roughly 5 minutes, and then we will go back and forth.

So, Mr. Jones, if you will proceed.

STATEMENT OF JOHN B. JONES, JR., CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. **Jones**. Thank you very much, Mr. Chairman.

I am honored to be here today to present the testimony of the Section of Taxation of the American Bar Association on this very important topic. I know the committee understands that I am presenting the position of the Section of Taxation and it's not a matter which the American Bar Association has had an opportunity to consider.

We think it is not surprising that when we have the tremendous number of tax-exempt organizations operating in this economy, that there is going to be a conflict in competition with taxable organizations in some very significant areas, and that conflict will change over time, it will get more intense. And we think this is clearly, as the questions this morning have suggested, the time to revisit these areas of competition to determine what changes can be adopted to make the rules fairer.

And we think it is also in the interest of the charitable organization that this examination take place because, in the long run, reasonable rules on business income will make charities last and have a rightful place in society.

Our comments, our written comments, go in some length to the development of the unrelated business income tax and the current law. We talk about the same lack of data which was referred to in the GAO report. We talk some about the experiences of the members of our section in enforcement of the law. We agree with those who have suggested that more data would help before significant changes are made. We also suggest that compliance with the current law could be improved if budgetary allocation were made for better training and retention of IRS specialists in the field, better data gathering by the Service itself, and enhanced enforcement.

We, as I think most of the people here have done, are limiting our comments to 501(c)(3) organizations and not considering others in the tax-exempt arena.

As we put this testimony together, we did focus on the historic unrelated activities of tax-exempt organizations, where the organization is pushing the limit of tax exemption. The examples that Mr. Schulze gave this morning are very good ones. And there the related/unrelated test has been the one that the Service has used.

We think that there have been many successes with that. It is a learning process. It's a difficult area, but generally the courts in the enforcement process have come together to give some meaning to related, and some of the problems might well be resolved within the framework of existing law.

As we reflect on other testimony which this committee has heard, it seemed to us that it may have focused on some activities which are clearly related and cannot be dealt with within the framework of the unrelated test. In a sense, it may go to the very purposes of the exempt organization itself, and these are very difficult problems.

In some of the areas, the exempt organization was there first. I speak as no expert, but if I look back to the days right after World War II, there were no private organizations in the research field or in physical education field. And it has been a recent phenomenon that has found out, perhaps in part because of the groundwork laid by the exempt organizations, that there is a role for profit organizations, too. That's a very difficult problem, if we have something that starts out as a legitimate tax-exempt activity, when and how can we put limits and have the charitable organizations pull out.

We are not here to oppose any change. But we do want to bring into focus the magnitude and depth of some of these problems that go to the exemption process itself.

I hope that people learn from the 1986 Tax Act that we do better in tax legislation if we take a broad view and try to do a comprehensive job in the area we're focusing on. Piecemeal change is apt not to be a permanent solution and only to provide problems further down the road.

So I hope that the committee, as it addresses these problems, will take the bigger picture and realize that these are very, very difficult problems and that not all truth is on one side.

Thank you, sir.

[The statement of Mr. Jones follows:]

STATEMENT OF JOHN B. JONES, JR.
ON BEHALF OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION BEFORE THE COMMITTEE ON WAYS & MEANS SUBCOMMITTEE ON OVERSIGHT UNITED STATES HOUSE OF REPRESENTATIVES CONCERNING INCOME-PRODUCING ACTIVITIES OF TAX-EXEMPT ORGANIZATIONS

JUNE 30, 1987

Mr. Chairman and Members of the Subcommittee:

I. INTRODUCTION

I am John B. Jones, Jr., Chair of the Section of Taxation of the American Bar Association and the Section appreciates this opportunity to present its views on appropriate federal policies related to the taxation of income-producing activities of tax-exempt organizations.1/ These views are presented only on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and accordingly should not be construed as representing the position of the entire Association.

If you have tax-exempt organizations in an economy as complex as our own, it is inevitable that there will be competition with taxable organizations in some significant areas. It is high time to revisit these areas of competition to determine if changes are needed to make the rules fairer. In the long run, charitable organizations will also benefit from reasonable restrictions on tax-exempt income from business sources.

The Section's comments discuss the development of the unrelated business income tax, current law, the lack of reliable data about unrelated activities, and the experience of members of the Section with the law, compliance and enforcement. The Section generally believes reliable data should be gathered prior to considering any significant change in current law, but also that compliance with current law could be improved by budgetary allocation for better training and retention of IRS specialists in the field, better data gathering, and enhanced enforcement. The GAO concluded that Section 501(c)(3) organizations "dominate" the tax-exempt community,2/ and the Section's comments are, therefore, directed to that class of tax-exempt organization.

1/ I present this testimony in my capacity as the Chair of the Section of Taxation. I am a member of the law firm of Covington & Burling in Washington, D.C. Like most active tax lawyers, I and my firm have as clients tax-exempt organizations which could be affected by legislation resulting from these hearings. Since no proposed legislation is pending before this Committee, Tax Section policies permit my appearance on its behalf with this disclosure.

2/ "United States General Accounting Office, Tax Policy: Competition between Taxable Businesses and Tax-Exempt Organizations," GAO/GGD-87-40BR (1987).

II. HISTORY OF UNRELATED BUSINESS INCOME TAXATION OF TAX-EXEMPT ORGANIZATIONS

The principal substantive provisions now contained in Sections 511 through 513 were first adopted in the Revenue Act of 1950. They were significantly expanded in their application by the Revenue Act of 1969, which also added the debt-financed income rules of Section 514, and amended in less significant ways by other tax acts. Section 511 imposes a tax on an organization's unrelated business taxable income (UBTI); Section 512 defines UBTI as gross income from an unrelated trade or business regularly carried on, less deductions directly connected therewith, and allows certain modifications; Section 513 defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related to the organization's exempt purpose, and Section 514 treats income from certain debt-financed property as UBTI. Section 515 allows the foreign tax credit in connection with UBTI.[3]

The Revenue Act of 1950[4] imposed a tax on the UBTI of certain organizations. The purpose was to prevent such organizations from unfairly competing with for-profit commercial enterprises. As stated more fully in the Senate Report:

> The problem at which the tax on unrelated income is directed is primarily that of unfair competition. The tax-free status of Section 501 organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. . . .
>
> In neither the House bill nor your Committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact, it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization. . . .[5]

The UBTI provisions of the Revenue Act of 1950 applied only to certain organizations. For example, churches and universities were not made subject to the UBTI provisions, although the UBTI provisions were extended to state and local universities in 1951. The Tax Reform Act of 1969 extended the unrelated business income tax to all organizations exempt from tax under Section 501(a) (other than Section 501(c)(1) organizations) in an effort to end any unfairness in taxing only some exempt organizations and not others on the same activity, subject to a special transitional rule for churches. The 1969 Act also adopted Section 514 of the Code and substantially revised certain provisions of Section 512 of the Code.[6]

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[3] Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 581 (1924).

[4] Ch. 994, 64 Stat. 906.

[5] S. Rep. No. 2375, 81st Cong., 2d Sess. 27 (1950) reprinted in 1950-2 C.B. 483, 504. See Latcham, "Private Charitable Foundations: Some Tax and Policy Implications," 98 U. Pa. L. Rev. 617, 646 n. 140 (1950).

Under the provisions enacted as described above, a tax-exempt corporation is subject to tax on its UBTI at the regular rate to which for-profit corporations are subject under Section 11. Tax-exempt trusts are taxed at the rate set forth in Section 1(e) of the Code.

III. CURRENT LAW CONCERNING THE TAXATION OF AN ORGANIZATION'S UNRELATED BUSINESS INCOME

A. Generally

To be considered to be an unrelated trade or business:

1. The activity must constitute a trade or business;
2. It must be regularly carried on; and
3. It must not be substantially related to the organization's exempt purposes.[7]

However, the term "unrelated trade or business" expressly excludes certain activities; those carried on by volunteers, those conducted primarily for the convenience of members, students, or patients, and the sale of donated goods.[8]

B. Elements of an Unrelated Trade or Business

1. Trade or Business

For purposes of the unrelated business income tax, the term "trade or business" has the same meaning that it has for purposes of Section 162 and includes any activity carried on for the production of income from the sale of goods or

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6/ P.L. 91-172, Section 121(d), 90 Stat. 1730 (1969). The 1969 legislation similarly was intended to prevent unfair competition. H.R. Rep. No. 413 (Part I), 91st Cong., 1st Sess. 44, 50 (1969). Notwithstanding the clear statutory history noted above, which shows that the UBTI provisions are directed at preventing only unfair competition, the IRS has taken the position that the potential for unfair competition is merely one factor to consider in determining whether an activity constitutes an unrelated trade or business and not necessarily even the primary factor. E.g., Clarence LaBelle Post No. 217 v. United States, 580 F.2d 270 (8th Cir.), cert. dismissed, 439 U.S. 1040 (1978).

7/ Regs. Section 1.513-1(a).

8/ Section 513(a)(1)-(3).

performance of services.[9] A passive activity does not constitute a trade or business.[10]

2. Regularly Carried On

The second element of an unrelated trade or business requires that the trade or business be regularly carried on. The IRS refers to the frequency and continuity with which the activity is conducted and the manner in which it is pursued. If the activity manifests a frequency and continuity and is pursued in a manner generally similar to a comparable activity conducted by a taxable entity, it is regularly carried on.[11] It appears clear that if an activity is only carried on annually, such as an annual fund raising ball, the activity is not regularly carried on.[12]

3. Substantial Relationship

The third and usually the most important element in determining whether an activity is an unrelated trade or business is whether the activity is substantially related to carrying out an organization's exempt purposes. This is discussed in greater detail below (See Section IV.).

C. Exclusion of Certain Types of Income from the Unrelated Trade or Business Tax

As noted above, certain types of income are not subject to the unrelated trade or business tax. For instance, so-called "passive" income, such as dividends, interest, annuities, royalties, rental income from real property and gains from sale or exchanges of property, are generally exempt from tax. Certain other types of income are also exempted for policy reasons, including income from certain research activities described in Section 512(b)(7), (8) and (9). Consistent with the grant of tax exemption, income from related activities is also exempt.

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[9] United States v. American Bar Endowment, 106 S.Ct. 2426, 2430 (1986). In 1969 Congress endorsed the so-called "fragmentation" rule by enacting Section 513(c). That section provides that an activity does not lose its identity as a trade or business merely because it is carried on within a larger complex of other endeavors which may or may not be related to the exempt purposes of the organization. United States v. American Bar Endowment, 106 S.Ct. 2426, 2430-33 (1986); United States v. American College of Physicians, 106 S. Ct. 1591, 1594 (1986).

[10] San Antonio District Dental Society v. United States, 340 F.Supp. 11 (W.D. Tex. 1972); Oklahoma Cattlemen's Association v. United States, 310 F.Supp. 320 (W.D.Ok. 1969). Early on the Treasury Department recognized that the mere passive receipt of revenues from rents, dividends and interest did not preclude exemption. Treas. Reg. 11, Section 29.101(6)-1 (1942). See generally Eaton, "Charitable Foundations, Tax Avoidance and Business Expediency," 35 Va. L. Rev. 807. 1003 (1949).

[11] Regs. Section 1.513-1(c)(1).

[12] Suffolk County Patrolmen's Benevolent Association v. Commissioner, 77 T.C. 1314 (1981). See also Revenue Ruling 75-201, 1975-1 C.B. 164.

D. Other Rules

In addition to the foregoing rules of general application, there are a number of rules of narrower application excluding (and in come cases including) income from certain activities in the measure of income subject to tax. In addition, administrative provisions require the filing of tax returns (on Form 990-T) relating to unrelated business income, and the payment of tax on UBTI.

IV. EXEMPT PURPOSES; THE RELATEDNESS TEST

A. Tax Exempt Purposes

Under Section 501(c)(3), an organization may qualify for tax-exempt status, assuming the other exemption requirements are met, if it is organized and operated for "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. . . ." It is obvious that these types of purposes which will qualify an organization for tax exemption are broad in meaning. Accordingly, the interpretation of whether a particular organization carries out one or more such purposes can be a difficult one. For example, educational purposes obviously include the operation of a school, but they also include operation of a symphony orchestra or museum.

Any organization may choose to conduct in a taxable manner activities which would otherwise qualify it for exemption. What distinguishes the conduct of activities for exempt purposes are the requirements that, for an organization to be exempt from taxation:

(1) No part of the organization's net earnings may inure to the benefit of any private shareholder or individual.13/

(2) The organization's assets must remain dedicated to exempt purposes. This requirement is enforced by the requirement of the regulations that the assets of an exempt organization must, upon dissolution, be distributed for one or more exempt purposes or to the federal government or a state or local government for a public purpose.14/

(3) The organization must serve public rather than private interests.15/

The foregoing requirements, taken together, insure that there is a significant public benefit served by the activities of an organization if it is to qualify for tax exemption. By contrast, a non-exempt organization need not serve public purposes and conducts its activities so as to maximize the return on its investment, the private profit of its owners.

13/ Section 501(c)(3).

14/ Regs. Section 1.501(c)(3)-1(b)(4).

15/ Regs. Section 1.501(c)(3)-1(d)(1)(ii).

B. The Relatedness Test

The grant of tax-exempt status to an organization obviously carries with it the exemption from tax of an income derived from an activity which is "related" to the carrying out of the exempt organization's exempt purposes. This is consistent with the rationale for tax exemption. Under the UBTI provisions, only the income from trades or businesses regularly carried on which are unrelated to the exempt organization's purposes are subject to tax.

It is easier to state the test than apply it. According to the most recent GAO report,[16] in 1985 there were 366,071 organizations which were tax exempt under Section 501(c)(3) of the Code. Although all of these organizations serve one or more of the exempt purposes listed in Section 501(c)(3) of the Code, they serve these exempt purposes in a myriad of ways. It is against the specific exempt purposes of each organization that the "relatedness" of each of its activities must be tested. Thus an activity which may be related for one exempt organization can be unrelated for another. The sale of scientific books is an unrelated activity for a tax-exempt art museum[17] but would likely be a related activity for a scientific museum.

An activity may serve both related and unrelated purposes, and, pursuant to the so-called fragmentation rule of Section 513(c) of the Code, the relatedness of each activity and each component of the activity is separately tested. For example, publication and sale of a scientific journal by a scientific organization is related and not subject to tax, but income from the sale of advertising in the journal would generally be unrelated and subject to tax.[18] Income from the sale of products produced in the conduct of exempt functions is related if the product is sold in the state that it is in on the completion of the exempt functions and the scope of the production activity is no greater than that required to carry out the exempt purposes. For example, in the case of an exempt organization engaged in a program of rehabilitation of handicapped persons, the sale of products produced by persons in the program would be related and exempt.[19]

Some additional examples may help to illustrate how the UBTI rules distinguish between competition and unfair competition and make income from the latter fully taxable.

Example 1

An institution of higher education exempt from tax operates directly a macaroni factory with employees hired for the purpose, and sells the macaroni through normal food distribution channels. All of the net income of the macaroni factory is used to provide for financially needy students of the educational organization. Under such circumstances the macaroni factory income would be fully taxed on the same basis as it would if the factory were operated by a taxable entity.

16/ "United States General Accounting Office, Tax Policy: Competition Between Taxable Businesses and Tax-Exempt Organizations," GAO/GGD-87-40BR (1987).

17/ Rev. Rul. 73-105, 1973-1 C.B. 264.

18/ Regs. Section 1.512(a)-1(f)(1). United States v. American College of Physicians, supra.

19/ Regs. Section 1.513-1(d)(4)(ii).

If the institution of higher education was a corporation, corporate tax rates would apply.

If, instead of being sold, 10% of the macaroni was used by the educational organization in its student dining halls, 10% of the activity of the macaroni factory would be related and exempt from tax and the net income related to 90% of production would be taxable even if some or all of the 90% of production were sold to other tax-exempt organizations.

If, however, the overall scope of the unrelated portion of the macaroni factory activity was "substantial" relative to the exempt activities which directly furthered the educational organization's exempt purposes, the educational organization could lose its tax exempt status.

Example 2

Assume that the facts are the same as in the foregoing example except that the macaroni factory is operated in the form of a wholly-owned, for profit, subsidiary of the education organization. The net income of the macaroni factory would be fully taxed.

The for-profit subsidiary (and its owner, the exempt organization) could not reduce the taxes on the income from the activity by having the subsidiary make tax deductible payments to is exempt parent in a passive form, such as rent, royalties or interest, which generally would be non-taxable to the exempt parent pursuant to the passive income exceptions to UBTI. Such a result is barred by Section 512(b)(13) of the Code which provides that interest, annuities, rents and royalties received by a tax-exempt organization from a taxable organization "controlled" by it (within the meaning of Section 368(c) of the Code) are taxable fully to the exempt organization if the activity of the controlled organization from which it derives its income would be unrelated if the activity were conducted directly by the exempt parent.

Generally the size and scope of a for-profit activity conducted by a taxable subsidiary, even if substantial, would not endanger the tax exemption of the parent. For this reason exempt organizations which conduct unrelated business activities of any significant scope generally conduct them in taxable subsidiaries as in this example.

Example 3

Assume the facts are the same as in Example 1 except that the educational organization conducts the macaroni manufacturing activity for the specific purpose of hands-on training for its students, which training is an integral part of the educational programs conducted by the educational organization. If the size and scope of the manufacturing activity was commensurate with the educational organization's exempt educational purposes served thereby, the net income derived from selling the macaroni would be related and exempt from tax if the macaroni was sold in the form in which it emerged at the end of the exempt educational manufacturing activity.

If, and to the extent, that the macaroni manufacturing activity exceeded the size and scope required to carry out the exempt educational purpose, the income would be taxable as UBTI.

If the scope of the unrelated portion of the macaroni factory activity was "substantial" relative to the exempt activities of the educational organization which directly furthered the educational organization's exempt purposes, the educational organization could lose its tax exempt status.

* * *

It is relevant to note that in each of the three examples the macaroni factory would compete with for-profit entities in whole or in part. However, as the examples illustrate, the law in the area effectively distinguishes between those situations in which the activity directly and substantially serves the exempt purposes of the organization conducting it, in which case the income from the activity is exempt from tax, and those in which the activity does not directly and substantially serve such purposes and is therefore commercial and fully subject to tax.

The foregoing examples suggest the complexity of applying the test of "relatedness" to exempt organizations' activities, given the diversity of purposes they serve and activities they conduct in furtherance of such purposes. Macaroni is easy. If the product is research or gymnasium playing time, the test becomes even more subjective. However, no one has yet suggested a more objective or fairer test to protect those activities that further the exempt purposes on which the grant of tax exemption is based.

The Code and Regulations define "unrelated" in a manner which insures that, unless there is a direct and substantial relationship between an activity and the exempt purposes of the tax-exempt organization's conducting it, the activity is unrelated and subject to tax. An activity is unrelated unless it is "substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501. . . ."20/

> Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross

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20/ Section 513(a). The regulations state than an activity is not "substantially related" to an organization's exempt purpose unless the activity "contributes importantly" to the accomplishment of an exempt purpose, and the relationship must be a "causal" one. Regs. Section 1.513-1(d)(2). In American College of Physicians, the Supreme Court held that the substantial relationship test requires that a court focus upon the manner in which the organization operates its business. 106 S.Ct. at 1600.

> income is derived must contribute importantly to the accomplishment of those purposes. . . . Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.
>
> In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.[21]

This language in the Regulations is faithful to the statutory intent and about as articulate a standard as can be expected absent specific examples.

V. LACK OF FACTUAL DATA ON UNRELATED BUSINESS INCOME ACTIVITIES OF EXEMPT ORGANIZATIONS

We agree with the recent GAO report that very little factual data on unrelated business income is available, either to the public or to the IRS.

To change the law in the absence of such data runs the risk that the significant and varied contributions made to society by exempt organizations could be impaired or lost at the very time that such organizations are increasingly relied upon to furnish such contributions and span the void left by reduction of government programs serving the same or similar purposes. Exempt organizations have often been innovators, initiating and developing programs which have proven the feasibility of and served as a model for expanded private and governmental programs.

The Section of Taxation supports the recent efforts of the IRS cited in the GAO Report[22] to assemble accurate factual data. In addition, the Section of Taxation supports the Taxpayer Compliance Measurement Program audit of 3,000 unrelated business income tax returns (Form 990-T) announced by the Internal Revenue Service on May 1, 1987, a program intended "to generate statistically accurate norms to help evaluate all Forms 990-T." In addition, the Section of Taxation, including its Exempt Organizations Committee, would welcome opportunities to work with the Internal Revenue Service to modify existing tax information and return forms, particularly Form 990-T, to assist the IRS in developing more useful and complete factual data.

21/ Regs. Section 1.513-1(d)(2),(3).

22/ "United States General Accounting Office, Tax Policy: Competition Between Taxable Business and Tax Exempt Organizations," supra, at pp. 13-14.

VI. COMPLIANCE WITH AND ENFORCEMENT OF THE TAX PROVISIONS RELATING TO UNRELATED BUSINESS TAXABLE TAXABLE INCOME

It is the perception of members of the Section of Taxation most familiar with UBTI issues that compliance with the law is not as great as it should be. This appears to result from several factors:

1. The law in the area is not well-defined in authoritative precedents in readily accessible form, or in comprehensive publications with the result that tax-exempt organizations and their advisors (and the general public) frequently are unaware of or misunderstand the law.

2. The tax return forms neither provide tax-exempt organizations with adequate guidance and assistance in interpreting the law nor furnish the IRS with the information appropriate to focus audit inquiries.

3. The IRS does not emphasize enforcement in the area and revenue officers are often inexperienced about UBTI issues.

The last point deserves some discussion. Although members of the Section of Taxation familiar with the tax-exempt organization area have dealt with many IRS personnel who are highly competent and experienced in the area, it appears that the IRS, whose principal mission is to collect tax revenue, has given relatively low priority to the UBTI area, except for a few prominent types of unrelated business. The area may not attract or retain the "best and the brightest" new IRS employees, presumably because work in the exempt organization area in the IRS would not appear to be the best stepping-stone for advancement for persons intending IRS careers nor the most marketable IRS experience for those who ultimately seek employment outside government. The combined effect of these factors, and what appears to be a relatively high turnover of IRS personnel in the tax-exempt organization area, is that, on average, IRS specialists assigned to the area tend to be less well-versed and experienced in their speciality than are, on average, IRS specialists in other areas.

VII. CONCLUSION

Substantial competition and overlap between tax-exempt organizations and ordinary taxpayers is inevitable. Congress must reexamine the common turf from time to time to see that the tax laws are not distorting the competition.

We applaud the Committee's study. We believe the basic statutory approach is sound. The difficulty in specifying what is "unrelated" stems from the variety of situations in which the problem arises. Improvements in the law are most likely to come in the form of detailed rules covering specific situations.

We share the concern of the GAO that there is insufficient data on which to base any large-scale legislation. We also believe that enforcement of existing laws has not been uniform or given a high priority. Specific budgetary allocation to IRS could deal with both the data problem and the enforcement problem.

The Section of Taxation will be pleased to work with those interested in an improvement of the law in this area.

Chairman PICKLE. Thank you, sir.

Before I recognize the next panel, are you suggesting we pass a bill something like the 1986 tax bill? [Laughter.]

Mr. JONES. I don't think the tax profession is ready for that yet, sir.

Chairman PICKLE. Well, we thank you very much for your comments, and we have your written statement and it will be made a part of the record.

Now, Mr. Lerner, if you will proceed.

STATEMENT OF HERBERT J. LERNER, CHAIRMAN, FEDERAL TAXATION EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LERNER. Thank you very much, Mr. Chairman.

I am Herbert J. Lerner, testifying today as chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants.

We encourage the subcommittee in its efforts in these hearings to proceed with caution with any change in the area of tax-exempt organizations until such time as a comprehensive well-reasoned framework for change can be designed. This would entail a review of the proper role of exempt organizations in our society, a long-term study of the competitiveness issue, enhanced data collection, and a better understanding of the capabilities and limitations of the existing system.

The AICPA Tax Division believes controversies surrounding competition between tax-exempt and for-profit organizations have been compounded by a number of factors, including a lack of comprehensive and authoritative guidance under existing law, inadequate resources applied by the IRS to enforce these laws, and limited or inadequate factual data on the extent and nature of this competition.

Various measures have been advanced prior to and during these years for improved Government oversight of nonprofit organizations. These options really are pointless, however, unless we are first able to determine exactly what unrelated business income means. And the critical question there is usually whether or not an activity is related to the organization's exempt purposes. That relatedness determination necessitates a rather subjective analysis of the facts and circumstances of each case.

And while we would always encourage the development of an objective test rather than a subjective test, we are not so confident that one can be developed applicable to the broad panoply of activities of exempt organizations. Nevertheless, we believe that the relatedness test should not be abandoned and replaced with another subjective test, such as a competitiveness test. Such a test would even be more subjective in that it would require that the economic impact of the nonprofit activities on each of its commercial competitors be assessed.

Taxing a nonprofit's activities merely because they have some economic impact on some for-profit entity would not be equitable.

Many exempt organizations which appear to be commercial in nature serve important cultural, educational and social purposes. Thus, it is very important that the reasoning behind the policy decisions granting exceptions and exclusions to the definition of unrelated trade or business income be considered in depth before any change is to be made.

Also, there is a lack of authoritative guidance in this area. In many instances, an exempt organization and its advisors have no published precedence to guide it, to determine whether an activity is unrelated. In these situations, often tax advisors look to private letter rulings involving similar fact patterns. However, private letter rulings are not binding authority for this purpose.

We would encourage an increased effort by the IRS with respect to the publication of revenue rulings to provide guidance to taxpayers in this area. As our written detailed testimony indicated, in the past 5 years, there have only been four published rulings dealing with the unrelated trade or business income issue. Increased publication would benefit both the Government and taxpayers by providing more uniform administration of existing law.

As you heard previously, the IRS recently announced a TCMP planned audit of 3,000 unrelated business income tax returns to generate statistically more accurate norms to evaluate the filing under existing law of form 990-T. The examination will focus on determining whether reported amounts on each line have been accurately dealt with.

The dual approach of forms 990 and 990-T inhibits the Service's ability to identify UBI issues and amounts because enforcement of unrelated business income issues, such as TCMP audits, will concentrate on organizations which have self-identified unrelated trade or business income and excludes organizations with more questionable activities that are reported solely on form 990. Therefore we would urge that the TCMP program be expanded to include examination of organizations that have not filed form 990-T.

We would also suggest that, in the future, the IRS ought to consider the unified reporting form of both the 990 and the 990-T to provide more detailed coverage on this subject. These suggestions wouldn't require significant additional effort by the exempt organization over existing requirements. It should enhance the Service's ability to enforce the existing laws more efficiently and effectively. And from our perspective, the improved efficiency and effectiveness of the administration of existing law would go a long way toward providing more fairness in this area.

The Tax Division welcomes the opportunity to work with your subcommittee and staff, the Treasury Department and the Internal Revenue Service in developing more comprehensive and authoritative guidance. And we appreciate the opportunity to appear before the subcommittee today.

Thank you.

[The statement of Mr. Lerner follows:]

Statement of Herbert J. Lerner
on Behalf of
the Federal Tax Division
of the
American Institute of Certified Public Accountants

I am Herbert J. Lerner, testifying today as Chairman of the Federal Taxation Executive Committee of the American Institute of Certified Public Accountants. The AICPA represents over 240,000 CPAs, many of whom serve as professional tax advisors to tax-exempt organizations, as well as volunteer board members of exempt groups.

In the past, the AICPA has cautioned against the accelerated pace and frequency of tax law changes. I am here today to urge that it is premature to proceed with any change in the area of tax-exempt organizations until such time as a comprehensive, well-reasoned framework for change can be designed. This process should include a review of the proper role of exempt organizations in our society, a long-term study of the competitiveness issue, enhanced data collection on exempt organization activities, and a better understanding of the capabilities and limitations of the existing system.

Over the past several days of hearings, you have heard much about the history and practices of tax-exempt organizations. Today, I will focus my comments on working with the existing law and Government oversight to improve the efficiency of the system and alleviate many of the concerns being raised. The Tax Division believes controversies surrounding competition between tax-exempt and for-profit organizations have been compounded by: (1) a lack of comprehensive and authoritative guidance under the law governing tax-exempt organizations; (2) a diminished effort to enforce these laws; and (3) limited or inadequate factual data on the extent and nature of this competition.

I. Appropriateness of "Unrelated" and "Trade or Business" Tests

The "relatedness" test is the threshold determination which must be made before any of the other issues related to these hearings can be considered.

Various measures have been advocated prior to and during these hearings for improving Government oversight of nonprofit organizations. These measures include enhanced enforcement by the IRS, limitations on or an outright prohibition of unrelated business activity, imposition of a higher tax rate on unrelated business activity income, improved recordkeeping and reporting, and repeal of various exceptions to the unrelated business income tax. However, these options are pointless unless we are first able to determine exactly what "unrelated business income" means. Generally, there is little or no dispute between the taxpayer and the IRS as to whether an activity is "regularly carried on" as a "trade or business." The critical question is whether or not the activity is "related" to the organization's exempt purposes.

Flaws in the "Relatedness" Standard: The "relatedness" determination necessitates a rather subjective analysis of the particular facts and circumstances of each case. Indeed, the SBA report[1] on unfair competition contends that the "relatedness test" is "ambiguous and difficult to apply to specific fact situations [and] it does not reach all the business activities it should." The SBA advocates that the "relatedness" standard be supplemented with criterion based on "the extent of the impact of the nonprofit's activities on commercial firms."

It would be commendable if an objective "litmus test" could be devised to easily distinguish between activities which should not be taxed because they conform to the nonprofit's exempt purposes and those activities which should be taxed because their nexus with exempt functions is too remote. Unfortunately, we do not believe such a standard could be devised. Furthermore, we do not believe that the "relatedness" standard should be abandoned and replaced with a "competitiveness" test. In fact, the courts are already looking at the conduct of tax-exempt entities to determine if an action is commercial in nature. This "commercial hue" interpretation of the existing "relatedness" standard would seem to fulfill the SBA's desire that competition be considered as a component of the judgement regarding relatedness.

Problems Inherent in a "Competitiveness" Test: We feel that a "competitiveness" test would be less desirable than the existing standard on grounds of both objectivity and equity. Such a test would be even more subjective than the existing "relatedness" test because it requires that the economic impact of the nonprofit's activities on each of its "commercial competitors" be assessed. This determination raises a number of difficult issues:

- How do we measure the impact of the nonprofit's activities on commercial firms? How can we distinguish between competitive problems of the commercial firm relating to the nonprofit's activities and internal factors such as poor management?
- At what point does the impact become so great that it converts the nonprofit's activities into a taxable event?
- If the nonprofit successfully competes with its commercial counterparts in one year but is less successful in the following year, is the tax imposed only in the first year or in both?
- Which commercial firms are to be included in the universe of the "competitors" of a particular nonprofit entity? Only firms in the same "line of business"? Are there geographical limitations in assessing impact of the nonprofit's activities?

Certainly these types of determinations are at least as subjective as the issue of "substantial relationship" to exempt purposes. The complexity of the competitiveness approach is exacerbated by the fact that it may require that the IRS examine the operations of numerous commercial firms in the same lines of business as the nonprofit simply in order to assess the tax liability of the nonprofit. For a nonprofit engaging in several different activities this could create a tremendous administrative burden on the IRS.

The "competitiveness" test is also defective in terms of equity. Taxing a nonprofit's activities merely because they have some economic impact on some commercial firm is simply not fair. Such an approach ignores the fact that many goods and services once provided almost exclusively by the nonprofit sector - home health care, fitness, and day care - have only recently been offered by commercial firms attracted by factors such as enhanced governmental support and reimbursement. Basing the taxation of a nonprofit's activities solely on the market entry decisions of a for-profit rival allows a limited number of entrepreneurs to determine the role of the nonprofit sector in our society. Such policy decisions are better left to the electorate through its representatives.

Many exempt organization activities which appear to be commercial in nature serve important cultural, educational, and social purposes. It is very important that the reasoning behind the policy decisions granting exceptions and exclusions to the definition of unrelated trade or business income be considered in depth before any change is made.

Existing "Commercial Hue" Criteria: The existing law has been interpreted by some to consist of a mere "relatedness" determination. This interpretation is not accurate. The courts have interpreted the existing statute to allow considerations as to the commerciality of an activity in reaching an unrelated trade or business determination. For example, in a recent case involving advertising[2], the Supreme Court ruled that an activity is unrelated to an organization's exempt purposes if the manner in which the activity is conducted reveals on overriding profit motive. The mere presence of a profit motive and commercial competition were not fatal. Rather, evidence that the activity was principally conducted in order to make money instead of intrinsically achieving exempt purposes was conclusive. Numerous other court decisions[3] have advanced the positions that commercial competition, accumulation of profits, and conduct of business operations in a manner suggesting a primary profit motive, are important factors in reaching a decision under the existing statute that an activity is not being conducted for purposes related to the exempt function. Thus, the proper approach to the issue of competitiveness is not new legislation, but rather improved enforcement of the existing law (including the "commercial hue" standard) by the IRS.

II. IRS Administration and Enforcement of Unrelated Business Income Tax Provisions.

Lack of Published Precedent: Tax-exempt organizations and the government would both benefit from an increase in authoritative guidance defining which types of activities are or are not unrelated trade or business activities.

A determination of whether a given activity is an unrelated trade or business usually depends on whether the activity is substantially related to an exempt purpose. Other situations involve a determination of whether the other two requirements for a finding of unrelated trade or business (i.e., a "trade or business" that is "regularly carried on") are met. Unfortunately, in many instances an exempt organization and its tax advisors have no published precedent to rely upon in deciding whether to treat an activity as unrelated. In these situations, tax advisors often look for private letter rulings (PLRs) or general counsel memoranda (GCMs) involving similar fact patterns. However, PLRs and GCMs are not precedent setting and, therefore, cannot be relied upon by taxpayers as binding authority. Also, in the unrelated trade or business area, PLRs and GCMs are sometimes contradictory and result in little or no guidance to taxpayers.

We believe that the IRS should place more emphasis on publishing authoritative guidance in this area. A review of the Cumulative Bulletin reveals that over the past five years only four revenue rulings on unrelated trade or business have been published. Increased publication of regulations and revenue rulings would benefit the government and taxpayers by promoting uniform administration of the law and by notifying taxpayers that certain activities are considered to constitute unrelated business. Taxpayers would also benefit from increased guidance in related matters, such as income and expense allocation.

Modification of Existing Compliance and Reporting Requirements: While the recently announced Taxpayer Compliance Measurement Program (TCMP) audit of 3,000 unrelated business income tax returns (Form 990-T) will assist the Internal Revenue Service in generating statistically accurate norms to help evaluate all Forms 990-T, the examination will focus on determining whether reported amounts on each line of a return are correct. This approach misses the more important question of whether each organization correctly classified its activities as "related" or "unrelated" in accordance with the law and IRS pronouncements. Many activities that are arguably related to an organization's exempt purpose will not be reported on Form 990-T. Rather, they will appear only on Form 990. The dual-return approach inhibits the Service's ability to identify UBI issues and amounts because enforcement of unrelated business income issues, such as the TCMP audits, concentrates on organizations who have self-identified unrelated income and excludes organizations with more questionable activities that are reported solely on Form 990. We would suggest that the 3,000 announced TCMP audits should be expanded to include examination of organizations that have not filed Form 990-T.

Another suggestion to reduce this inherent conflict might be to combine the two returns into a unified reporting form -- perhaps by requiring organizations with unrelated income to file an additional schedule to their Form 990, as charitable organizations exempt under Code section 501(c)(3) must now generally file Schedule A containing required supplementary information. Additional disclosure might also assist in this area. For example, the existing Form 990 could be modified to highlight sources of income and to justify the reason for reporting it as exempt from income taxation.

These suggestions would not require significant additional effort from the exempt organization over existing requirements, yet would enhance the Service's ability to enforce the tax code efficiently and effectively.

Additional Trained Personnel Needed: We believe that the Service has not placed enough emphasis on enforcement of requirements relating to exempt organizations and unrelated business income. Certainly, while many IRS examining agents and other IRS personnel working in the EO area are competently performing their jobs, the EO area in general is perceived by some as being a low profile, unglamorous area in which to work. We would support efforts by the Service to emphasize the obtaining and training of additional personnel to concentrate in this important specialty area.

III. Conclusion:

The AICPA Tax Division welcomes the opportunity to work with Congress, the Treasury Department, and the Internal Revenue Service toward developing comprehensive and authoritative guidance, formulating additional disclosure requirements, and designing expanded reporting forms for tax-exempt organizations. Should the Subcommittee so desire, we would be pleased to survey the Tax Division's membership to aid in the data gathering process and in the identification of specific problem areas.

We appreciate the opportunity to provide this testimony and would be pleased to respond to any questions you might have.

1. U.S. Small Business Administration, Office of Advocacy - *Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s* (June 1984) pp 38.

2. *United States v. American College of Physicians*, 106 S. Ct. 1591, 1594 (1986).

3. *Presbyterian and Reformed Publishing Co. v. Comm'r.*, 743 F.2d 148, 84-2 USTC Para 9764, 54 AFTR 2d 84-5730 (3d Cir. 1984); *Greater United Navajo Development Enterprises, Inc. v. Comm'r.*, 74 TC 69 (1980); *BSW Group, Inc. V. Comm'r.*, 70 TC 352 (1978); and *Pulpit Resource v. Comm'r.*, 70 TC 594 (1978).

Chairman **Pickle**. Well, we thank you, Mr. Lerner. You've given us some good suggestions and good copy. I wish we had more time. We'll try to come back with some questions for you.

Mr. **Lerner**. Thank you, sir.

Chairman **Pickle**. Now, Carolyn Clark, representative of the Bar of New York City.

Ms. Clark.

STATEMENT OF CAROLYN C. CLARK, CHAIR, COMMITTEE ON NONPROFIT ORGANIZATIONS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Ms. **Clark**. Mr. Chairman and members of the committee, my name is Carolyn Clark. I am speaking this morning on behalf of the Committee on Nonprofit Organizations of the Association of the Bar of the City of New York.

The association is an organization comprised of 16,000 lawyers, most of whom practice in the New York City area. The members of my committee are lawyers who have a particular interest in legal issues affecting nonprofit organizations.

To answer the important questions being raised by these hearings, the Committee on Nonprofit Organizations urges that a systematic study be undertaken of the income-producing activities of nonprofits to determine if unfair competition exists and, if so, whether the appropriate response is an increased effort to enforce existing law, or if, instead, new legislation is required.

The nonprofit community in general finds the provisions of the Internal Revenue Code, which deal with unrelated business income, workable and proper. The claims of unfair competition appear to be based largely on anecdotal evidence which we submit is not sufficient as a matter of policy to allow the Congress to formulate sound legislative proposals.

Questions to be addressed in such a study would include whether unfair competition exists between for-profit and nonprofits and, if so, to whom is the competition unfair? Do businesses run by nonprofits in fact expand at a faster rate? And is there any connection between such expansion and the tax benefits provided to the nonprofits? No systematically gathered evidence exists of the history of pricing behavior of nonprofits.

In studying competition, the study should consider the impact of the competition not only on the competing entities but also on the consumer. Do the claims of unfair competition depend upon who first enters a particular field? What is the true balance of tax advantages between for-profits and nonprofits under our existing Federal income tax laws?

In contrast to the claims that the nonprofits compete on a playing field that is systematically tilted in their favor by the Tax Code, we suspect that a thorough study of the tax system as a whole would establish that this system does not consistently favor nonprofit organizations but, instead, can best be viewed as a bumpy playing field. Some provisions of the Internal Revenue Code favor for-profits but not nonprofits, and vice versa.

I'm sure we all agree that privately administered philanthropy has made and continues to make an important contribution to our society. Government has contributed to this healthy environment in many ways, not the least of which is by providing tax benefits. This is a cost which the Congress in the past had always considered worth incurring.

This committee would welcome the opportunity to work with you in planning and implementing such a study. We applaud the announcement by the Internal Revenue Service of the formation of an exempt organization advisory group. Consultation with this advisory group of distinguished and knowledgeable professionals could provide welcome insights for the recommended study of income producing activities of nonprofit organizations.

Mr. Chairman, you asked at the outset for our reaction to the Treasury report. I applaud the thoughtful analysis submitted by Treasury at the beginning of these hearings, and I think it is important to emphasize that the Treasury also agrees that the lack of detailed information prevented them from making actual legislative proposals. As I read their testimony, their proposals are issues they think deserve further consideration and with that, I certainly agree.

I thank you very much for the opportunity to speak before you and would be happy to answer any questions.

Thank you.

[The statement of Ms. Clark follows:]

TESTIMONY FOR HEARINGS BY THE SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, TO REVIEW THE UNRELATED BUSINESS INCOME TAX ON BEHALF OF THE COMMITTEE ON NON-PROFIT ORGANIZATIONS, THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

My name is Carolyn C. Clark. I chair the Committee on Non-Profit Organizations of the Association of the Bar of the City of New York. The Association is an organization comprised of over 16,000 lawyers, most of whom practice in the New York City area. While most reside in New York, many reside in other states and foreign jurisdictions. The members of the Committee are lawyers interested in the legal problems of non-profit organizations, including lawyers who act as general counsel to, or director of, such organizations, law school professors who study this area, attorneys working in regulatory agencies, and private practitioners who represent non-profit organizations of various types, as well as attorneys. The Committee studies, reports on and proposes legislation that affects non-profit organizations.

The Committee believes that those sections of the Internal Revenue Code which deal with the taxation of unrelated business income and, more broadly, with the qualification of organizations for exemption from Federal income tax are workable and proper. Nevertheless, we recognize that the questions that are being raised at this hearing are important ones. The answers to these questions could profoundly affect the non-profit sector as well as the general public. We therefore appreciate the opportunity to share with you our questions and concerns.

I am sure we all agree that privately-administered philanthropy has made and continues to make an important contribution to our society. Charitable organizations directed by private individuals have made significant contributions in education, in science, in health care and in the arts. Among other things they have fostered an environment for debate, experiment and innovation.

Government has contributed to this healthy environment in many ways, not the least of which is by providing tax benefits. This is a cost which the Congress has always considered worth incurring.

Over the years, the tax system has occupied a central role in the regulation of the non-profit sector. We do not question, and in fact we support, the need for such regulation. However, our Committee suggests that the Congress should proceed with caution before recommending changes in those sections of the Code which provide for tax exemption and address unrelated business taxable income. A delicate balance currently exists, and severe damage to the non-profit sector, as well as the general public, could result from amending these laws without sufficient information concerning the need for, or the likely effects of, any such amendment.

The Congress, the Internal Revenue Service and both the for-profit and non-profit communities currently suffer from a dearth of information concerning competition between non-profits and for-profits. The Internal Revenue Service acknowledges this lack and is now initiating a new examination program, which should be complete within two years, to compile data by reviewing Forms 990-T, the form used by non-profits to report taxable income. A similar acknowledgment appears in a study issued on February 27, 1987 by the General Accounting Office entitled "Competition Between Taxable Businesses and Tax-Exempt Organizations".

This Committee urges that the Congress undertake a study to provide reliable information as to the nature, scope and competitive effects of income-producing activities conducted by the tax-exempt sector. With such information, a determination can be made whether abuses do in fact exist and, if so, whether they can be eliminated by enforcing, rather than by amending, the current law. In each instance where abuses are documented and it is determined that current law does not provide a satisfactory solution, any proposed amendment should be drafted carefully to eliminate the abuse but not unduly impair the ability of philanthropy to contribute to society.

The study should address certain essential questions: Does any "unfair" competition exist and, if so, to whom is it unfair? Do the claims of unfair competition depend upon who first enters a particular field? What is the true balance of tax advantages between for-profits and non-profits in our Federal tax system? And, what do we mean by a "subsidy"?

I. Does any "unfair" competition exist and, if so, to whom is it unfair? The Committee is aware that certain segments of the for-profit community perceive that such competition exists. To date, the claims of unfair competition by non-profits appear to be based on a number of anecdotes. In contrast, systematic gathering of reliable data would be required to determine whether businesses run by non-profits do in fact expand at a faster rate and whether any connection exists between such expansion and tax benefits provided to the non-profits. No evidence exists of the history of pricing behavior of non-profits, so no proof exists that non-profits routinely undercut the prices of for-profits. Even if such evidence existed, would the result of undercutting be unfair? Certainly not to the general public purchasing products at lower prices. In studying competition, one should consider its impact not only on the competing entities but also on the consumer.

II. Do the claims of unfair competition depend upon who first enters a particular field? When for-profits enter a field in which non-profits operate, such as hospital administration, do for-profits exhibit less concern about competition than when the situation is reversed?

III. What is the true balance of tax advantages between for-profits and non-profits under our Federal tax system? Before legislating in this area, the Congress should examine this balance carefully. At these hearings, this Committee may well hear claims that tax benefits provided to non-profits unfairly favor those institutions.

Such a claim is questionable. We doubt that a dispassionate study would conclude that the tax system, viewed as a whole, tilts in favor of non-profit organizations. The Committee suspects that the answer is much more complicated. We suspect that the tax system as a whole does not consistently favor non-profit organizations but instead can be viewed as a bumpy playing field. Some provisions of the Internal Revenue Code favor for-profits, but not non-profits, and vice versa.

As only suggestive examples of some sections in the Code which benefit for-profits but not non-profits consider the following:

- Historically, the combined effect of the accelerated cost recovery system and investment tax credit provided the possibility of a negative income tax for certain for-profits but not non-profits.
- Section 168(h) of the Internal Revenue Code prevents tax-exempt organizations from enjoying the substantial benefits of leasing which are available to for-profit organizations.
- While the net operating loss carryover rules of § 172(b) technically apply to non-profits as well as for-profits, as an administrative matter, the Internal Revenue Service tends to deny the benefit of the carry forward of start-up losses to non-profits by requiring that non-profits which enter a new business area develop a profit history before net operating loss deductions will be permitted.
- While for-profits enjoy liberal rules for deducting expenses, non-profits must follow more restrictive rules under § 512 governing the allocation of expenses and deductions between exempt and non-exempt purposes.
- For-profits may take advantage of deferred compensation plans for their employees while non-profits are severely restricted in their use of non-funded deferred compensation plans under § 457.

A careful review of the Code would reveal other such instances. This Committee questions whether, as a matter of public policy, non-profits should be burdened to any greater extent than they currently are.

IV. What do we mean by a "subsidy"? Many persons automatically refer to the tax treatment of non-profits, their exemption from Federal income tax and the deductibility of contributions to non-profits as a "subsidy" provided by the government. Such a characterization may well be inaccurate. Noted scholars propose that the so-called tax benefits result in fact from the definition of the tax base, a definition which does not properly include charitable contributions or revenues raised by non-profits. Under this theory, the government foregoes no revenues otherwise due to it but merely acknowledges that the manner of defining the tax base results in a certain treatment of non-profits. In making recommendations, the study should consider such an analysis, whether or not it is ultimately adopted by the Congress.

This Committee stands ready to assist in the development of the information which the Congress needs before formulating legislation in this area. In this connection we note that among a number of conferences which will be focusing on this topic, the Center for Entrepreneurial Studies at the New York University Business School is co-sponsoring this fall a research conference with the Yale Non-Profit Program to discuss issues related to competition between non-profits and for-profits. Other existing materials which are relevant to these considerations are listed in the two exhibits attached to this testimony: a list of selected reference materials (Exhibit A) and a paper by John Simon entitled "The Tax Treatment of Non-profit Organizations: A Review of Federal and State Policies," 1/ from which the Committee gleaned many of the observations, included in this testimony (Exhibit B).

If at the conclusion of these hearings, the House concludes that a study along the lines we have outlined is in order as a prelude to determining whether any legislative change is necessary, the Committee on Non-Profit Organizations stands willing and ready to work with the House Committee to plan and implement this study, to suggest possible participants and to make suggestions for its agenda as well as to cooperate in any other manner the House Committee finds useful. We applaud the June 3 announcement by the Internal Revenue Service of the formation of an Exempt Organization Advisory Group. Consultation with this Advisory Group of distinguished and knowledgeable professionals could provide welcome insights for any study of income-producing activities of non-profit organizations.

1/ John G. Simon, The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies; from Powell, ed., The Nonprofit Sector: A Research Handbook (Yale University Press 1987).

Exhibit A

Statement of Carolyn C. Clark

Selected and Preliminary List of Reference Materials
Prepared by Professor Harvey Dale, New York
University Law School, Study on Law and Philanthropy
[to be Expanded].

1. Hansmann, The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms, 40 NAT'L TAX J. 71 (March 1987).
2. GENERAL ACCOUNTING OFFICE, TAX POLICY: COMPETITION BETWEEN TAXABLE BUSINESSES AND TAX-EXEMPT ORGANIZATIONS (GAO/GGD-87-40BR Feb. 1987).
3. Herzlinger & Krasker, Who Profits From Nonprofits?, 65 HARV. BUS. REV. 93-106 (Jan.-Feb. 1987).
4. Copeland & Rudney, Business Income of Nonprofits and Competitive Advantage, 33 TAX NOTES 747-56 (Nov. 24, 1986).
5. Copeland & Rudney, Business Income of Nonprofits and Competitive Advantage -- II, 33 TAX NOTES 1227-36 (Dec. 29, 1986).
6. Davidow, Service's Liberal Position on Health Clubs May Have Adverse Repercussions, 64 J. TAX'N 292 (May 1986).
7. Gannaway, Joint Ventures for Profit and Nonprofit Corporations as Partners in Providing Mental Health Services, 5 PUB. L. FORUM 201 (Spring 1986).
8. Marmor, Schlesinger & Smithey, Museum's Gift Shop and Catalog Sales Generally Exempt From Unrelated Business Taxable Income of Section 511, 27 TAX MGMT. MEMO. 87 (March 31, 1986).
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10. Simpson & Powell, Does Income of Exempt Scientific Research Organizations Come from Unrelated Business?, 64 J. TAX'N 210 (April 1986).
11. Squiers, Corporate Restructuring of Tax-Exempt Hospitals: The Bastardization of the Tax-Exempt Concept, 14 LAW, MED. & HEALTH CARE 66 (April 1986).
12. Yang, Collaboration Between Nonprofit Universities and Commercial Enterprises: The Rationale for Exempting Nonprofit Universities from Federal Income Taxation, 95 YALE L.J. 1857-81 (July 1986).
13. Harris, SBA Study on Tax-Exempts Causes a Stir, 28 TAX NOTES 941 (Aug. 26, 1985).
14. Hasso, A Potpourri of 'Hot' Unrelated Business Tax Issues, 14 N.Y.U. CONF. TAX PLAN. CHARIT. SECTOR 16-1 (1985).
15. Ives, Allocating Fixed Costs or Dual-use Facilities by Exempt Organizations: Actual Use or Availability for Use?, 42 WASH. & LEE L. REV. 333 (Winter 1985).
16. Liles, Cls. Ct. Rules Research Institute Had No UBTI, 63 J. TAX'N 402 (Dec. 1985).
17. Shillingburg, Using Merchandise Sales to Advance Exempt Purposes, 14 N.Y.U. CONF. TAX PLAN. CHARIT. SECTOR 13-1 (1985).

18. Silverberg, Strategies for the Unrelated Business Income Tax Audit 'Run, Duck, or Fight.', 14 N.Y.U. CONF. TAX PLAN. CHARIT. SECTOR 14-1 (1985).

19. Stewart, The Premium Gambit, 14 N.Y.U. CONF. TAX PLAN. CHARIT. SECTOR 12-1 (1985).

20. Sugarman, Planning Techniques for Operating an Unrelated Business, 14 N.Y.U. CONF. TAX PLAN. CHARIT. SECTOR 15-1 (1985).

21. Wittenbach & Gallagher, The Tax Implications to Exempt Organizations of Six Income-Producing Activities, 16 TAX ADVISER 170 (March 1985).

22. Bowman, Charitable and Nonprofit Organizations-Income From Commercial Operations [Canada], 32 CANADIAN TAX J. 329 (March-April 1984).

23. Monroe, Collaboration Between Tax-Exempt Research Organizations and Commercial Enterprises Federal Income Tax Limitations, 62 TAXES 297-316 (May 1984).

24. Turkel, Mark D., Business Activities (Related and Unrelated) of Tax-Exempt Organizations and Their Tax Consequences, 13 N.Y.U. CONF. CHARIT. FOUND. 2 (1983).

25. Ellman, Another Theory of Nonprofit Corporations, 80 MICH. L. REV. 999-1050 (April 1982).

26. Emory, Swenson, & Lerner, UBI Exists Though Paying Entity Has NOL, 57 J. TAX'N 182 (Sept. 1982).

27. Katsh & Davidow, 'ASME' Brings Major Problems for Nonprofit Groups, 4 LEGAL TIMES WASH. 13 (May 31, 1982).

28. Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 STAN. L. REV. 1017-39 (1982).

29. Stern, The Conversion of Health Maintenance Organizations From Nonprofit to For-Profit Status: Background, Methodology, and Problems, 26 ST. LOUIS L. REV. 711-26 (April 1982).

30. Stern, The Conversion of Operating Charitable Enterprises From Nonprofit to For-Profit Status: Background, Methodology, and Problems, 16 BEVERLY HILLS BAR ASS'N J. 85 (Spring 1982).

31. Hansmann, The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation, 91 YALE L.J. 54-100 (November 1981).

32. Hansmann, Consumer Perceptions of Nonprofit Enterprise: Reply, 90 YALE L.J. 1633-38 (June 1981).

33. Note, Dissolution of Public Charity Corporations: Preventing Improper Distribution of Assets, 59 TEXAS L. REV. 1429-59 (November 1981).

34. Permut, Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann, 90 YALE L.J. 1623-33 (June 1981).

35. Thomas, Preventing Nonprofit Profiteering: Regulating Religious Cult Employment Practices, 23 ARIZ. L. REV. 1003-32 (Summer 1981).

Exhibit B

Statement of Carolyn Clark

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From Powell, ed., The NonProfit
Sector: A Research Handbook
(Yale University Press, 1987)

The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies

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JOHN G. SIMON

In the long history of charity and nonprofit institutions, there may never have been an epoch free of controversy over taxation, but the past forty post–World War II years have witnessed an unremitting state of siege. Since the days of the pharaohs and continuing through the church-state conflicts of the Middle Ages, there have been occasional perturbations over the granting—and termination—of tax relief for churches (Genesis 47:26; Adler 1922; Larson & Lowell 1969). Skirmishes of the past, however, were no more than isolated forerunners of the strife—over the taxation of both religious and secular nonprofits—that has prevailed in contemporary America. Since 1945, concern with federal, state, and local tax treatment of nonprofit institutions has produced at least eight congressional investigations and hearings, half a dozen major federal statutes (taking up some five hundred pages in the Internal Revenue Code and Regulations), and a succession of state and local wars over real property tax exemption. Indeed, this chapter has been written in the midst of yet another storm generated by Treasury tax-reform proposals, which, even as softened by President Reagan and the House of Representatives, would significantly reduce the tax incentives for charitable giving.[1] With nonprofits receiving $50 billion in federally deductible contributions, generating roughly $110 billion in fee, sale, and investment revenue exempt from federal income tax, and holding an estimated $300 billion in real estate exempt from state and local property taxes,[2] it is little wonder that hard-pressed nonprofit institutions and deficit-ridden governments find themselves recurrently at war.

There are those who yearn, in different ways and for different reasons, for the status quo ante tax. Thus, many nonprofit managers would prefer a life uncomplicated by tax rules; champions of altruism would rather see charitable behavior flowering without tax inducement; and some tax

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I am grateful to Boris I. Bittker, Paul J. DiMaggio, Henry Hansmann, Michael Krashinsky, and Walter W. Powell for detailed and thoughtful criticism of a draft of this chapter, and to the dozens of colleagues and students at the Yale Program on Non-Profit Organizations and the Yale Law School with whom, over the years, I have explored the issues covered in this chapter. I also express appreciation to the Rockefeller Foundation for the opportunity to work on this project during a period of resident study at the foundation's Bellagio Conference and Research Center.

[1] These proposed changes are described in n5, and in the text.

[2] These are the author's rough estimates for 1985. The revenue estimate is based on the conservatively low 1980 figure of $76 billion for charitable organizations (see text under "Support Function in Practice"), increased by 30 percent to account for inflation and by another 10 percent to include noncharitable nonprofits (the 10 percent figure is derived from chapter 4 in this volume). The revenue figure is not the same as a taxable income figure (see text below), but it is used here because revenue data are often used in the debates over tax exemption. The deductible contribution figure is based on a 1982 estimate derived from Clotfelter (1985, 6) and U.S. Internal Revenue Service (1982), increased to take account of inflation and the estimated amount of nonitemizers' contributions not deductible in 1982 but deductible in 1985. The real estate figure is derived from chapter 4 in this volume (based on Ruggles & Ruggles 1980) and increased for inflation, resulting in a figure of roughly $300 billion for the entire nonprofit sector, including organizations whose property is not tax-exempt. I have estimated that the amount of real estate held by such organizations is so small in comparison to the property held by exempt organizations, that the $300 billion figure can be used for the exempt group as well as the slightly larger nonprofit universe.

scholars and reformers would like to rededicate the tax system to revenue production, freed from the ancillary baggage of charitable "subsidy." In a society suffused with taxes and reliant on them as engines of social and economic policy, however, the union of charity and taxes is in reality indissoluble—and controversy therefore inevitable. Charity seems destined to be enmeshed in tax policy debate not only because so is everything in our society but also because, over the years, we have come to entrust to the tax system a central role in the nourishment and regulation of the nonprofit sector.

Thus, at the federal and state levels, we use the taxing laws for these purposes:

1. To encourage through relief from tax—what some call subsidy (to be discussed below)—the continuation and expansion of the nonprofit sector. We may call this the *support* function.

2. To bring about through application of certain exemption criteria a degree of equalization or redistribution of resources and opportunities, or at least a discouragement of unacceptable forms of discrimination. We may call this the *equity* function.

3. To regulate through tax mechanisms the fiduciary behavior of nonprofit managers. We may call this the *police* function.

4. To regulate through tax mechanisms the capacity to which nonprofit organizations can operate in the business and public sectors by competing with, controlling, or influencing the behavior of commercial or governmental entities. We may call this the *border patrol* function.

Each of these functions is a major focus of tax policy debate (with the most elaborate controversy surrounding the first), and each, in turn, will be analyzed in this chapter, along with a summary of the research—both empirical and theoretical—that has been done, or needs to be done, under each heading. To carry out this analysis, however, we need to disaggregate the nonprofit sector; its subspecies (some of them legal artifacts) are subject to very disparate treatment under the tax laws and require separate scrutiny. Indeed, the manner in which the tax laws have carved up the sector is itself an important object of policy controversy that deserves to be dealt with under each of the four headings.

We start, therefore, with a taxonomy of these subspecies and the way they are treated under the federal tax system. It will serve as a rudimentary review of the federal tax treatment of the nonprofit sector. The federal taxonomy will then be used as the framework for a tabular outline of the way in which state laws categorize and treat the nonprofit sector and of the federal nontax consequences that are influenced by the tax system rules. After that, we will plunge into the policy analysis.

AN OUTLINE OF THE TAX TREATMENT OF THE NONPROFIT SECTOR

A Federal Tax Taxonomy

The nonprofit sector is subject to special treatment under federal individual and corporate income taxes, estate and gift taxes, and certain excise taxes. There are, in fact, four separate treatments, one for each of four principal categories into which the federal tax laws divide the nonprofit sector. In figure 5.1 each category is represented by a ring embracing a set of organizations that are subject to a substantially similar tax regime, distinct from the regimes applicable to the adjoining rings. The rings are so arranged that together they make up a group of concentric circles, which, as one moves outward from Ring IV, contain increasingly larger portions of the nonprofit world.

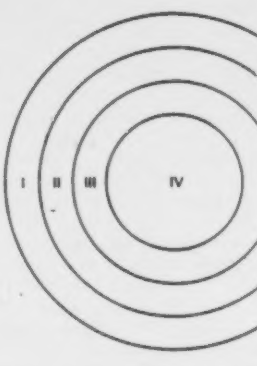

FIGURE 5.1 A SCHEMATIC SKETCH OF NONPROFIT TAX CATEGORIES

Thus, the full circle, encompassing Rings I through IV, includes all entities that are exempt from federal income tax (the tax otherwise imposed on corporations, unincorporated associations, or trusts) under the principal exemption statute, §501 of the Internal Revenue Code. Almost all these groups share the condition of being organized on a not-for-profit basis, which means not that the entity is forbidden to generate a profit but that any such profits may not be distributed to owners or other private persons;[3] Hansmann (1980) refers to this rule as the "nondistribution constraint." This constraint is imposed on these institutions by the legal instrument under which they are organized under state law—the "charter" or "articles" in the case of a nonprofit corporation or an unincorporated association, or the "deed of trust" or other trust instrument in the case of a charitable trust (Fremont-Smith 1965). (Which of these legal forms of organization a nonprofit group adopts is almost wholly irrelevant for determining that group's federal tax treatment.)

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[3] Membership corporations that finance farm crop operations and are exempt under §501(c)(16) are permitted to issue capital stock and distribute dividends to participating members, subject to certain constraints.

The Charitable-Noncharitable Distinction

There is a basic distinction between Ring I and the Rings II–IV circle, however. Groups in Rings II–IV are not only nonprofit but also what are loosely referred to by tax lawyers as the "charitables"—organizations described in §501(c)(3) of the code as serving "religious, charitable, scientific, testing for public safety, literary or educational purposes." The shorthand "charitable" is used for these Rings II–IV groups, even though it is only one of several adjectives used in §501(c)(3), because "charitable" is the residual category used to classify these groups when they do not fit under any of the other adjectives and also because the Supreme Court has held that all §501(c)(3) groups must conform to common-law charitable criteria.

In Ring I are the *non*charitable nonprofits that are listed throughout the succeeding subsections of the exemption statute, in §§501(c)(4)–(21): here we have social clubs, veterans' organizations, labor unions, burial societies, chambers of commerce, marketing cooperatives, and other associations that may roughly be described as carrying forward the private interests of the members but subject to the nondistribution constraint. Bittker and Rahdert (1976) describe these as "mutual benefit" organizations, as distinct from the §501(c)(3) charitable groups, which they characterize as "public service" organizations. Weisbrod (1980) distinguishes the Ring I from the Rings II–IV groups (to use our labels) on the basis of the greater tendency of the latter groups to provide "collective goods," often referred to as "public goods"—benefits that are not captured only by the persons or institutions generating the benefits. The tax system criteria for §501(c)(3)—Rings II–IV—treatment will be further described later in this chapter. Apart from criteria, what are the *results* of landing in the Rings II–IV circle—within the charitable §501(c)(3) set? Several consequences will be described below, but the most celebrated one is that contributions of cash or property (but not services) to these charitable groups are deductible by individuals and corporations for income tax purposes (under §170 of the code) and also deductible for estate and gift tax purposes (under §§2055, 2522). Gifts to Ring I organizations are not deductible, except for veterans' groups, nonprofit cemetery companies, and fraternal beneficiary organizations that use the gift for charitable purposes. (Further details of the deductibility distinctions are set forth in table 5.1.)

Distinctions within the Charitable World

Starting in 1954, and more ambitiously in 1969, Congress made distinctions—created a class system, some would say (Bittker 1973)—*within* the §501(c)(3) charitable world, which is why it is shown as a three-ring circle (II–IV) in our diagram. The charity world was first divided into two parts: the "private foundations" (Rings III and IV) and the groups that were *not* "private foundations" (Ring II). The private foundations were defined as constituting all groups that flunked certain tests set up by §509 of the code. To pass these tests, a group must be a school, a church, a hospital (or hospital-related research entity), or a group that meets one of several alternative (and fairly complicated) definitions of a "publicly supported" organization. Organizations meeting these tests (and certain variations upon them)[4] are, in the language of the tax bar, "public charities" (not to be confused with the broader set of §501(c)(3) charities), and they escape private foundation classification, with all the disabilities that attach to that status. This subdivision was meant to separate grant-making organizations (embracing the Ford Foundation and lesser dispensers) from the operating charities. It was in the former camp that more fiscal abuses were thought to lie, more political activism, more "unaccountable" wealth, more of all kinds of other problems, and, in any event, it was thought that dollars given to grant-making foundations entered the stream of active charitable use more slowly than gifts to operating nonprofits (a proposition discussed below).

Distinctions within the Foundation Category

In the midst of the 1969 congressional deliberations, however, it was discovered that the private foundation category, as pending legislation defined it, included all kinds of non-grant-making bodies that did not happen to be schools, churches, hospitals, or publicly supported. Many research institutions, social action groups, museums, and other nonprofits would fall afoul of the private foundation strictures. Congress could have moved them into public charity (Ring II) status, but, instead, it subdivided the foundation world (the Rings III–IV circle) into the "operating foundations"—Ring III—and the "nonoperating foundations" (the grant-making ones)—Ring IV. Probably the most important legal feature of the operating foundation is that it spends 85 percent of its income on the active conduct of its charitable program (as compared to grant making). Operating foundations receive more favorable treatment in several respects than do their nonoperating counterparts, as we shall see when we summarize the ring-to-ring progression in terms of tax benefit and regulatory burden.

This somewhat amoebic subdivision repeated itself in August 1984. For the purpose of giving certain operating foundations the benefit of public charity treatment in two respects (cited below), Congress carved out a subset of the Ring III world and called it the "exempt operating foundation"—an operating foundation that (1) had that status at the start of 1983 or, if not, had a past history of being publicly supported, and (2) had a board that was "broadly representative of the general public" and was not donor controlled—no officers and not more than a quarter of the board were persons

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[4] One variant that permits a donor to retain some of the features of a private foundation but at the same time to operate free of private foundation rules is the supporting organization—one that is operated in close conjunction with, and is intended to benefit, one or more public charities (§509(a)(3)). (This section contains the following classic example of code-speak: "For the purposes of this subsection, an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).")

TABLE 5.1 AERIAL VIEW OF FEDERAL TAX TREATMENT OF NONPROFITS

Glossary: Ring I: groups covered by §§501(c)(4)–(23)—noncharitable nonprofits. *Rings II–IV:* all §501(c)(3) groups—the charitable nonprofits. *Ring II:* the subset of §501(c)(3) groups covered by §509—groups exempted from private foundation status, known as public charities. *Rings III–IV:* the subset of §501(c)(3) groups *not* covered by §509—the private foundations. *Ring III:* private operating foundations. *Ring IV:* private nonoperating foundations.

A. Numbers (all estimated)

	Ring I	Ring II	Ring III	Ring IV
Number of units filing returns plus churches[a]	477,000 ('84)	690,000 ('84)	2126 ('83)	23,600 ('83)
Assets	N.A.	$480B ('82)	$7B ('83)	$64.5B ('81)
Revenue	$30B ('84)	$196B ('82)	N.A.	$6B ('81)
Expenditures	N.A.	$194B ('84)	$457M ('83)	$5B ('83)
Employees	.5M ('82)	6.5M ('82)	N.A.	7,000 ('85)
Value of volunteer labor	$8B ('85)	$52B ('80)	N.A.	N.A.

Sources: American Association of Fund-Raising Counsel, 1985; Foundation Center, 1985; Hodgkinson and Weitzman (1984, and the 1986 2d edition); chapter 4 and chapter 20 in this volume; author's extrapolations from the foregoing.

N.A.: Not available; M: Millions; B: Billions.

B. Exemption and Eligibility for Deductible Gifts and Foundation Grants

	Ring I	Ring II	Ring III	Ring IV
Exempt from corporate (and trust) income tax?	Yes	Yes	Yes	Yes
		Exception for I–IV: tax on unrelated business income		
			Exception for III, IV: excise taxes, see below	
Individuals' gifts to the organization deductible for income tax purposes?	No (except for veterans' organizations, cemetery associations, and some fraternal organizations)	Yes (up to 50% AGI)	Yes (up to 50% AGI)	Yes (up to 30% AGI) (Property gifts limited to 20% AGI and not always deductible at full value)
		(II–III, limit of 30% AGI for property gifts)		
Corporations' gifts to the organization deductible for income tax purposes?	No (except for veterans' organizations, cemetery associations, and some fraternal organizations)	Yes (up to 10% taxable income)	Yes (up to 10% taxable income)	Yes (up to 10% taxable income)
Bequests to the organization deductible for estate and gift tax purposes?	No	Yes (no limit)	Yes (no limit)	Yes (no limit)
Eligible for foundation grants?	No (unless special controls to assure exempt use)	Yes	Yes (but expenditure responsibility on grantor to police grantee use of funds)	Yes (but expenditure responsibility on grantor; see also pass-through rules under payout requirement)

AGI: Adjusted gross income

C. Regulation (general)

	Ring I	Ring II	Ring III	Ring IV
Degree of regulation of fiduciary conduct and exempt behavior	Light; mainly limited to checks on personal gain	Substantial: mainly under "operated exclusively for charitable purposes" clause	III–IV: Intense. Rules on self-dealing, §4941; payout, §4942; corporate control, §4943; speculative investing, §4944; miscellaneous, §4945[b]	
Required reporting and level of audit	Form 990: rare audit	Form 990; more audit than for Ring I	Form 990–PF; very detailed and heavy level of audit (paid for by §4940 audit fee tax)	
Liability for excise taxes in support of regulatory system	None	Imposed only for exceeding lobbying limits (see Part D)	III–IV: 2% audit fee[c] and penalty taxes on foundations and managers for violating above rules	

TABLE 5.1 (Continued)

D. Regulation of Certain "Political" Activities

	Ring I	Ring II	Ring III	Ring IV
Electoral campaigning	OK for most organizations	Banned	Banned	Banned
Nonpartisan voter registration	OK	OK	III–IV: OK if carried out on 5-state, multidonor basis	
Legislative lobbying	OK	OK if (a) "insubstantial" or (b) within percentage spending limits[d]	Banned except to defend legal status, for "nonpartisan analysis study and research," and in response to legislative request	
Monitoring executive branch activity	OK	OK	OK	OK
Public interest litigation	OK	II–IV: OK but subject to IRS rules to prevent abuses, limit fees		
Publishing "political" material not violative of above prohibitions	OK	II–IV: OK but if organization is classed "educational," presentation must be "full and fair" (this rule held unconstitutional by a federal court)[e]		

E. Eligibility under Other Federal Tax Provisions

	Ring I	Ring II	Ring III	Ring IV
Ability to offer employees annuities with tax benefits similar to those under a qualified pension plan?	No	Yes	Yes	Yes
Exemption under Federal Unemployment Tax Act?	No	Yes	Yes	Yes
Tax-exempt bonds issued by state or local government for support of the organization subject to volume limitations?	Yes	No	No	No
Exemption from federal gambling tax?	No	Yes	Yes	Yes

a. Ring I and II figures are misleadingly low because they are based on the number of units in the IRS Exempt Organizations Master File, which does not include (a) branches of national Ring I or II organizations filing on a consolidated basis, (b) Ring II organizations excused from filing because their annual revenues are below certain floors established by the Treasury (currently $25,000), and (c) churches. An estimate of the number of churches has been added to Ring II; no estimate was possible with respect to the other two categories.

b. The payout rule does not apply to Ring III foundations (although they are required to make annual direct (essentially nongrant) expenditures in an amount close to the payout required of Ring IV organizations). One of the miscellaneous rules ("expenditure responsibility") does not apply to the new "exempt operating foundation" subspecies referred to in the text.

c. The audit fee is not imposed on "exempt operating foundations."

d. To come within these percentage limits, an election must be filed. Churches are not permitted to file such an election.

e. See footnote 50, this chapter.

related to major donors. Because of the limited (though not trivial) legal consequences of exempt operating foundation status, we have not created a separate ring (perhaps Ring II.5) for this subsubspecies.

Other Nonprofit Species

The reader may wonder where among these rings certain nonprofits reside. Take community foundations, for example. These grant-making pools of many endowed funds dedicated to local or statewide purposes and administered by a broadly representative distribution committee (for philanthropic decisions) and by trustee banks (for investment decisions) qualify, for the most part, as public charities (Ring II) because of the multiplicity of their funders. They are not to be confused with community chests (typically part of the United Way system), another form of Ring II organization that solicits mainly nonendowment contributions from the public

TABLE 5.2 AERIAL VIEW OF STATE TAX TREATMENT AND FEDERAL NONTAX TREATMENT OF NONPROFITS

	Ring I	Ring II	Ring III	Ring IV
A. State Tax Issues				
Exemption from real property tax?	No (except cemeteries and often veterans', fraternal, labor, agricultural groups)	Yes (but some exceptions)	Yes	Usually
Exempt from corporate income tax?	Yes	Yes	Yes	Yes
Eligible for income tax-deductible gifts?	No	Often (sometimes "tracks" federal rules)	Often	Often
B. Federal Nontax Issues				
Eligible for nonprofit postal rates?	Mostly no	Yes	Yes	Yes
Exempt from involuntary bankruptcy proceedings?	No	Yes	Yes	Yes
Exempt from antitrust laws and F.T.C. Act?	No	For most purposes, no		
Exempt from securities regulation laws?	No	For some puposes, yes		
Exempt from buyer liability under Robinson-Patman Act?	No	Yes	Yes	Yes

Sources: Federal statutes; Lashbrooke 1985; Hansmann 1980.

and channels them largely to member agency public charities. Corporate foundations are treated like any other grant-making Ring IV foundation, except that their resources come from a corporate donor (which often provides trustees and staff to the foundation from among company personnel). Lying outside these rings are still other nonprofits. Political parties are treated by a separate part of the code that both exempts part of their income and taxes part of it (for example, investment income). The funds that finance pension plans are covered by yet other code sections that exempt their investment income if they meet various qualifying criteria. Although some cooperatives are found within Ring I, consumer and farmer cooperatives are covered by special sections that, directly or indirectly, permit cooperative income to go untaxed.

Consequences of the Categories

What consequences attach to landing in one or another of the four rings? Table 5.1 answers this question in summary fashion, compressing in an inevitably oversimplified chart a complex regulatory scheme. After providing a few items of quantitative information about the organizations, the table provides highlights of federal tax treatment of nonprofits—and thereby displays certain overall legislative patterns. With respect to the *degree of regulation*, the reader will notice that here, as in Dante's circles of hell, the situation worsens (from the perspective of the nonprofit organization) as we move from outer to inner circles: the scope of the regulation, the strictness of standards, the strength of sanctions, and the obligations of disclosure all increase. When we look at the *degree of tax benefit*, however, the progression across the rings is rather different. We travel from the least-favored-nation status of Ring I to the most-favored position of Ring II and then part (but not all) of the way back down the benefit scale as we cross Rings III and IV. Combining these patterns, we see that, as we go from mutual benefit groups (Ring I) to the public interest organizations (Rings II–IV), Congress increases the level of benefit and, in rough exchange, imposes a higher behavioral standard. However, *within* the public interest or §501(c)(3) realm (the Rings II–IV circle), the benefit-regulation trade-off ends, resulting in decreasing benefits *and* increasing regulation as we move from the most- to the least-favored charitable classes—from the public charities of Ring II to the grant-making foundations of Ring IV. (This pattern, however, does not apply to section E of the table, which refers to some miscellaneous tax provisions not involving tax exemption or deductibility.)

Table 5.1, it should be noted, represents the legal situation as of early 1986. Tax-reform legislation passed by the House of Representatives in late 1985—and awaiting an uncertain fate in the Senate—would affect a few of the provisions summarized in this table,[5] but not its overall configuration.

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[5] The House bill would affect various provisions summarized under part B of table 5.1: as noted in the text, the bill would end tax exemption for some of the organizations referred to in part B of table 5.1 that are nonprofit commercial-type insurance companies; the bill would limit the deductibility of gifts of appreciated property because of the alternative minimum tax provisions referred to in the text; and the bill would require any tax-exempt organization owning more than 5 percent of the shares of a corporation to pay an unrelated business income tax on the 10 percent of the dividends received from the corporation that was deducted by the corporation under the provisions of the bill. In addition, the House bill would reduce the ability of charitable organizations to offer tax-sheltered annuities to their employees and would impose a ceiling on the volume of tax-exempt bond financing that could be used to assist such organizations; these are issues listed in part E of table 5.1. As this chapter was being sent to press, the Senate Finance Committee had tentatively decided to oppose some of the House strictures but no bill had been reported out of committee.

State Tax and Federal Nontax Taxonomies

As a sequel to the federal tax chart, we look at a similar picture of the *state* tax consequences and the federal *nontax* consequences that flow from an organization's placement in one of the four rings (table 5.2). The state tax picture is necessarily vague and sketchy, for it seeks to summarize briefly the varying tax treatments of fifty states (some of which give local option to municipalities), treatments that usually employ definitions of nonprofit species that do not neatly fit within the federal tax categories (see Lashbrooke 1985).

This brief *tour d'horizon* has touched glancingly upon some aspects of the four main functions—support, equity, police, and border patrol—served by the tax treatment of the nonprofit sector. Thus, we have observed the greater degree of *support* provided to Rings II–IV organizations compared to Ring I groups; the less-favored treatment of private foundations (Rings III and IV), partly reflecting *equity* concerns provoked by the wealth associated with foundations; the fiduciary regulation to which the tax laws subject all nonprofits in varying degrees—a *police* function; and the limits on political activity imposed with differential intensity on Rings II–IV groups as an aspect of *border patrol*. We now turn to a closer look at these four functions, examining the policy controversies relating to each of them under federal and (less intensively) state tax law, as well as the research that informs, or might yet inform, these issues.

THE SUPPORT FUNCTION OF NONPROFIT TAX LAW

The assistance provided by the federal tax system is widely perceived as an important part of the explanation for America's robust nonprofit sector. Even though Schuster (1985) has noted that Western European tax systems provide more support to nonprofit arts organizations than is usually recognized, his study demonstrates (pp. 5–6) that the deductibility features of American tax law are more favorable to charitable organizations than any Western European tax regime. What is the rationale for this tax largesse and what arguments surround it? What are the consequences of this support? What can research tell us about these matters?

The Support Function in Theory: Search for a Rationale

Is Support the Rationale for Exemption and Deductibility?

Controversy greets us at the very mention of a support function. Some tax scholars, while acknowledging that tax exemption and deductibility nourish nonprofit organizations, deny that support is the point of these provisions. Instead, it is contended that an accurate and internally consistent definition of taxable income for federal purposes, or of taxable property for state purposes, explains exemption and deductibility and that a support or subsidy rationale is neither needed nor accurate. In other words, if an item of revenue or property is not a proper part of the tax base in the first place, then the nontaxable treatment of that item should not be characterized or explained as support for the nonprofit sector.

The Tax-Base-Defining Rationales. First, we consider rationales for the *exemption from federal income tax*. Bittker and Rahdert (1976) argue that, for charitable nonprofits (Rings II–IV), this exemption arises from (1) the fact that the income tax focuses on business and other activities pursued for personal gain—an underlying objective that does not apply to charitable entities, and (2) the fact that we cannot calculate the tax that would be imposed on these organizations. With respect to the latter point, the tax system does not tell us which expenditures made by charities are offsets to gross income, and we therefore cannot calculate taxable income. Moreover, our ignorance of the tax posture of the ultimate charitable beneficiaries makes it impossible to calculate the tax rate that ought to be imposed on the charitable entity that is supposed to be the surrogate for these beneficiaries.

For what we have called the Ring I groups (the mutual benefit entities), Bittker and Rahdert explain the exemption not as a subsidy but as a recognition of the fact that some activities "consist simply in the members' doing together what they could do separately without income tax consequences" (p. 358); on the other hand, they contend, revenue from investments or sales to nonmembers should not be entitled to exemption at all.

With respect to all Rings I–IV groups, exemption from corporate income tax can be understood in another way: Goode (1951, 40) states that one possible rationale for the corporate income tax is that it reduces inequalities of wealth and income among individuals resulting from stock-ownership and dividends; Goode points out that the corporate tax supplements the individual income tax by "reduc[ing] the amount of capital gains on stock which are traceable to retained profits, and in view of the preferential taxation of capital gains this narrows an important loophole in the individual income tax" (p. 205). The corporate income tax, however, has no inequality-reducing or loophole-narrowing function to perform with respect to a *nonprofit* corporation's taxable shareholders, for, by definition, the nonprofit has no such shareholders. This rationale, like those mentioned earlier, is in the tax-base-defining category; it has no "subsidy" elements.

Second, turning to the *deductibility under the federal income tax* of charitable contributions to Rings II–IV organizations, Andrews (1972) and Bittker (1972) have started with the venerable Haig-Simons definition of taxable income as the sum of a taxpayer's (1) consumption and (2) wealth accumulation (increase in net worth) during a given tax-reckoning period (Simons 1938). An item of revenue received by the taxpayer and then given away to charity during the same period does not increase the taxpayer's net worth. Moreover, it is argued that this pair of transactions does not constitute consumption, which, for income tax purposes, "may well be thought to encompass only the private consumption of divisible goods and services whose consumption by one household precludes their direct enjoyment by others"—private goods and services, in economics terminology (Andrews 1972); by contrast, charitable contributions buy only *public* goods and services. The charitable deduction simply gives effect (somewhat indirectly) to this proposition that income, when properly defined, does not include receipts thereafter contributed to charity (see also McNulty 1984). It should be noted that this rationale for deductibility does not necessarily justify a deduction for the full market value of appreciated property gifts; thus, Andrews (1972) suggests that, even under his theory, the gain portion of such property should not escape capital gains tax by reason of being given to charity.

Third, although Bittker and Andrews have not advanced an analogue to the income-defining rationale that would explain the *estate tax charitable deduction*, I have briefly explored such an estate-defining theory (Simon 1978, 22–23):

> Just as income is based on consumption and accumulation and the [income-defining] rationale asserts that this consumption is the private consumption of non-"public" . . . goods and services, we can perhaps say that the definition of personal wealth for estate tax purposes should refer to those assets available for the private accumulation or consumption of non-"public" . . . goods and services. A testamentary charitable contribution reduces the amount of assets available for such private consumption and accumulation; hence, under this analysis, it is logical to exclude these contributions from the definition of wealth for purposes of the estate tax.

Fourth, turning to the *state property tax exemption* of charitable organizations, Heller has provided what might be called a "property tax-base-defining" explanation for nontaxation (Yale University Program . . . 1982). Searching for theories that may be used to construct or define the property tax base, that is, "the general regime that defines which forms of . . . wealth are property to be taxed," he comes up with five alternative rationales: the property tax as an indirect charge for benefits, the property tax as a complement to the federal income tax, the property tax as land use regulator, the property tax as a wealth tax, and the "customary" definition of the property tax. Heller looks at each of these rationales to determine whether any of them necessarily suggests the inclusion of nonprofit organizations in the property tax base. His answer is that none of them does, and that therefore the exemption of charities can be explained on a tax-base-defining rather than a support or subsidy basis. (Tax-base rationales are discussed further in Swords 1981, 200–26.)

Implications of These Rationales. All four of these accounts point toward a rejection of the customary assumption that federal or state tax exemption or deductibility for the nonprofit sector represents an act of subvention, a bestowal of largesse.[6] The implications of rejecting this assumption are profound. Quantitative limitations on exemption or deductibility become very difficult to justify: how and why do we limit a taxpayer's charitable deductions to 50 percent of adjusted gross income for an individual or 10 percent of net income for a corporation, and how and why do we impose a 2 percent tax on a foundation's investment income,[7] or how can we contemplate a ceiling on the estate tax charitable deduction (see Bittker 1976), if the amounts involved should not be included in the income or estate tax base to begin with?[8] And how and why does a state grant property tax exemption to some charities and not to others (Swords 1981), if their property is excluded from the tax base from the start?

Moreover, acceptance of an income, estate, or property tax-base-defining rationale avoids the adverse pressure on tax exemption or deductibility that arises out of "tax expenditure" accounting for these tax provisions—accounting that yields the estimate, for example, that in fiscal 1984 the federal government "spent" $9.2 billion in forgone tax revenues resulting from charitable deductions. Such tax expenditure calculations buttressed the Treasury Department's explanation of its 1984 recommendations for a floor on charitable deductions equal to 2 percent of adjusted gross income (U.S. Treasury Department 1984). In addition, a rejection of subsidy labels also makes it more difficult to challenge, under the First Amendment's Establishment Clause, the current tax treatment of churches (Joblove 1980); if this treatment does not represent subsidy, how can it represent constitutionally impermissible support of religion?

As a final set of consequences of accepting the tax-base-defining approach, instead of a support or subsidy approach, consider the impact on the equity, police, and border patrol functions of nonprofit tax policy. If exemption and deductibility do not represent a subsidy, the protests against *inequitable* subsidy (tilted in various ways more toward the rich than the poor) lose much of their force. Similarly, it is much more difficult to justify the federal government policing role discussed below—regulating the fiduciary conduct of nonprofit managers through the tax system—if the policing is not tied to what can be called a federal subsidy. Finally, the justification for border patrol restrictions under the tax code—fencing nonprofits out of adjoining sectors—recedes if these constraints cannot be considered to be a condition of subsidy. A subsidy rationale, for example, undergirded a 1983 U.S. Supreme Court decision ~~upholding one important~~ aspect of border patrol: lobbying restrictions. These rules were attacked as an unconstitutional discrimination between charities, subject to lobbying restrictions, and veterans' organizations, *not* subject to lobbying restrictions, even though both types of organization enjoy the right to receive deductible contributions.[9] The Court stated, without explanation, that "tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system," having "much the same effect as" or being "similar to cash grants," and, indeed, constituting an expenditure of "public moneys."[10] Having assumed the existence of a subsidy, the Court went on to hold that it is "not irrational for Congress to decide that, even though it will not subsidize substantial lobbying by charities generally, it will subsidize lobbying by veterans' organizations."[11] If tax exemption and deductibility were not regarded as subsidies, the Court could not have reasoned as it did, and the case might have had a different outcome.

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[6] For example, this assumption was made without discussion in two *New York Times* opinion pieces one week apart. An op-ed article by Amitai Etzioni on March 4, 1985, argued that charities deserve "government support" but that this support should be provided "outright" rather than "indirectly, via the tax code." And an editorial on March 11, 1985, referred to charitable deductions as a "government subsidy."

[7] §4940, I.R.C. This excise tax, originally set at 4 percent under the Tax Reform Act of 1969, was justified by the tax-writing committees of Congress principally as a fee to compensate the government for the special auditing expenses said to be associated with foundations. Nevertheless, it has been characterized as an incursion on the principle of tax exemption for charities (Bittker & Rahdert 1976).

[8] Michael Krashinsky, in a memo to me, has pointed out that a limit on deductibility may not be inconsistent with the tax-base-defining rationale: the limit may only be a way of cutting down on some forms of abuse that are correlated with donations beyond certain percentages of incomes or estates.

The Limited Popularity of the Tax-Base-Defining Approach. The Supreme Court's subsidy assumptions are not idiosyncratic. Despite (or perhaps in part because of) the dramatic consequences that would flow from acceptance of the tax-base-defining rationales for tax exemption and deductibility, they have not been widely embraced (see, for example, Surrey 1973). Part of the explanation may lie in their novelty. To be sure, Harvard president Charles William Eliot attacked the idea of exemption as subsidy a century ago (Commission . . . 1975, 107), and one of the arguments for the charitable deduction when it entered the present tax law in 1917 resembled the not-part-of-consumption theory mentioned above (Commission . . . 1975, 106). But very little of the literature advancing a no-subsidy rationale appeared before 1972, and some of it came even later.

In addition, some aspects of this rationale appear to be inconsistent with long-standing tax doctrines or provisions. Thus, the income-defining and estate-defining theories of deductibility "bump into a countervailing theme in tax law: the ability to control the disposition of assets has often seemed to be a touchstone of taxability. . . . When one makes a gift to charity, this very act controls the disposition of assets—a fact that may therefore seem inconsistent with the notion that these same gifts reduce the . . . taxpayer's income or estate" (Simon 1978, 23). Similarly, the concept that federal income tax and state property tax exemption is tax-base-defining rather than subsidy depends in part on viewing "charitable organizations as conduit-type entities, a perspective which requires us to look at the beneficiaries of the nonprofit organizations—and their ability to pay" (Yale University Program . . . 1982, 6). Standard tax doctrine, however, resists the conduit characterization of a corporation or trust (Bittker 1981, chaps. 81, 90). Congress has explicitly departed from standard doctrine to provide for conduit treatment of certain Ring I organizations—social clubs, homeowners' associations, and mutual savings banks (Hopkins 1983, 4, 16)—as well as for-profit corporation-partnership hybrids (so-called subchapter S corporations, §§1361–79, I.R.C.), but it is not clear that it meant to relax the no-conduit doctrine in the case of charitable corporations and trusts.

Some tax code provisions on charity, too, are awkward for those advancing a tax-base-defining rationale. The percentage limitations on individual and corporate deductibility and the excise tax on foundation investment income, already mentioned as difficult to justify under a tax-base-defining rationale, are themselves suggestive that the Congress did not have such a rationale in mind.[12] It may also be argued that the no-consumption theme—crucial to the Andrews-Bittker income-defining rationale for deductibility—is undermined by the fact that no deduction is allowed for gifts to *individuals*, as compared to organizations, outside of the family or household; it is hard to see why a gift to a stranger, poor or rich, is consumption, whereas the gift to a charity is not.[13] However, administrative reasons that are consistent with the no-consumption theory—rather than doctrinal muddiness—may explain the rule that only organizations are eligible: it is a way of making it "practical to establish and audit the amount of redistribution from donors to recipients" (Andrews 1972, 351).

A further source of rebuttal to the tax-base-defining rationales lies in the history, ancient and recent, of tax policy for nonprofits. Early exemption of churches from royal or feudal taxes was based on the need to promote God's works, and the legislative history of the American tax code is punctuated with support explanations.

True, there are several historical supports for a tax-base-defining theory. An early reason advanced in favor of deductibility, as already noted, had an income-defining ring to it. Moreover, one basis for exemption of church property was that "it ceased to be under human control when it was devoted to God" (Belknap 1977, 2027, quoting Stimpson)—the property was no longer part of any human tax base. Added support for the tax-base-defining approach comes from a statutory antecedent to the modern income tax, the Civil War income tax statute, which specified the organizations subject to taxation without including charitable entities, thus implying that the income of charities was not thought to be part of the tax base at all. Rusk (1961, 10–11) suggests that "exemption" language was included in the later (1894) general income tax "just to be sure," and that therefore "the notion of exemption is something of an accident of legislative drafting convenience." And the draftsman of the 1913 Revenue Act "argued in Congress against an explicit expansion of its exemption clauses to embrace 'benevolent' and 'scientific' organizations, on the ground that the statutory reference to 'net income' automatically excluded all non-profit organizations" (Bittker & Rahdert 1976, 303).

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[9] *Regan* v. *Taxation Without Representation of Washington*, 461 U.S. 540 (1983). With respect to the differential treatment, see part B of table 5.1.

[10] 461 U.S. at 544–5.

[11] Ibid., at 550.

[12] But see Krashinsky's rebuttal, *n* 8.

[13] I am indebted to Paul DiMaggio for this point about strangers.

Most of the argumentation in favor of the tax exemption and deductibility, however, has sounded other themes—of public benefit or reduction of government burdens. The burdens point is said to explain state property tax exemptions enacted in the nineteenth century (Adler 1922). And public benefit was the argument made in 1917 by Senator Hollis, one of the authors of the charitable deduction provision: that the imposition of heavy World War I taxes would hurt charitable institutions by tempting "wealthy men . . . to economize. . . . They will say, 'Charity begins at home' " (Commission . . . 1975, 106).

Adverting to these problems with the tax-base-defining rationales does not mean that they should be rejected. There are rebutting arguments that can be offered, such as the point that it is an odd subsidy to charity whose size is adventitiously determined by reference to a variable—the tax rate schedule—that is not fixed with charitable subsidy in mind.[14] Some day the tax-base-defining rationales, and the counterarguments, will receive the full-fledged analysis they deserve as an important part of the nonprofit tax policy research agenda. At this time, I can do no more than sketch the broad outlines and implications of this important set of explanations for exemption and deductibility, and some of the difficulties—and then proceed, as now, to consider the rationales that accept the premise of support or subsidy.

Support or Subsidy-Based Rationales

Even after tax-base rationales have been put aside, the search for a straightforward justification of tax exemption and deductibility for nonprofits, on the ground that they serve important values and need support, does not turn out to be trouble-free. The quest bumps into several issues raised by those who have studied some of its dimensions.

Why a Subsidy for Nonprofits? The issue of support through tax exemption and deductibility is prefaced with the question: why a government subsidy at all? And this question comes in two parts: Why a subsidy for this particular social function (for example, health or education)? And why a subsidy to *nonprofits* carrying out this social function? The first question has a fairly familiar answer: where the production of certain goods or services yields external benefits to the larger society, and where normal market operations result in a less than socially optimum supply of that good or service, public subsidy is in order.[15] But, turning to the second question, we have to ask why direct government provision, or a subsidy to for-profit providers, would not be a satisfactory way of subsidizing production, without relying on nonprofit organizations.

Direct government provision is, of course, the way we obtain armies and most of our police, roads, and sewers. For goods and services like culture, health, welfare, education, and protection of civil rights and the environment, however, nongovernmental provision is often assumed to be preferable, for any one of a number of reasons:[16]

- Because only a part of the polity wants the good or service, despite its public or collective goods character—a circumstance especially likely to obtain in relatively heterogeneous societies like ours (Weisbrod 1977, and see chapter 22 in this volume).
- Because, even if the good or service is widely demanded, its provision by the government may be constitutionally prohibited (notably in the case of religion under the First Amendment) or inherently impractical (as in the case of monitoring, evaluation and criticism of government activities).
- Because, even if the good or service is in fact forthcoming, the *manner* in which it is provided will be constrained if the government itself offers it, as a result of majoritarian and egalitarian norms that bind the government and may be inconsistent with the values of innovation, quality, and freedom of inquiry in educational, cultural, and scientific affairs (see chapter 3 in this volume, where this is called the categorical constraint).
- Because government provision may be less efficient than nonprofit provision (in terms of cost per unit of production) as a result of the ability of the nonprofit to impose user fees where the government would find it hard to do so, or the nonprofit's ability to attract volunteer labor to the enterprise (see chapter 22 in this volume).
- Because use of nonprofits offers the possibility of decentralization of decision-making authority, thus serving the values of heterodoxy and participation.

These arguments against government provision are not universally accepted. They provoke protest, for example, that is based on a preference for majoritarian governance at all levels and in all contexts,[17] or based on fear of factionalism resulting from atomized decision making,[18] or based on equity concerns about the power held by the more affluent participants in the nonprofit sector (to be discussed below). It is beyond the scope of this essay to resolve these dilemmas; I seek only a plausible, not a dispositive, explanation for the subsidization of nonprofit institutions, and the concerns about government "monopoly" clearly contribute to such an explanation.

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[14] I am indebted to Michael Krashinsky for this observation.

[15] These are typically circumstances in which the good or service is, in whole or in part, what economists call a "public good" or "collective good" (referred to above), the benefits of which cannot be captured by any one user to the exclusion of others.

[16] Here and in other places in this chapter I recite arguments for or against various policies, arguments that may sound either normative (what makes good policy sense?) or positive (what explains policy decisions?). For the most part, I mean to set forth positive arguments, even though the considerations that lead policymakers to behave the way they do are often normative in nature.

[17] This preference is reflected in the opposition to the practice of municipal (governmental) hospitals contracting with voluntary (private nonprofit) hospitals for the delivery of medical services and in a June 30, 1978, *New York Times* article headlined "Private Charity Going Out of Style in West Europe's Welfare States."

[18] Although a supporter of the nonprofit sector, Lyman (1981) has discussed the possibility that its vaunted pluralism can lead to factional-

Reluctance to rely exclusively on government providers, however, does not necessarily point us in the direction of nonprofits. Why not subsidize *for-profit* enterprises to carry out these functions? (See chapter 2 in this volume.) Subsidizing proprietary organizations is, after all, a familiar American activity, which nourished many of our infant industries and continues apace, as any opponent of oil-drilling expense deductions or the Lockheed or Chrysler "bailouts" will readily recount. The contract failure theory (Hansmann 1980; Nelson & Krashinsky 1973) suggests one problem with using for-profits: difficulties in obtaining or evaluating information may make it difficult for donors or consumers to police their contracts or the use of their gifts. This contract failure steers donors and consumers toward nonprofits whose managers are prevented by law from retaining profits and who thus have less incentive to engage in exploitive behavior. (For comments on contract failure, see Krashinsky [1984] and Ellman [1982].) An important research task, as contract failure's principal exponent readily agrees (Hansmann 1980), is to test empirically the trusting behavior, on the part of donors and consumers, that the theory hypothesizes,[19] and also to test the notion that nonprofit managers are *in fact* worthy of this trust (see Clark's critique [1980] of this notion).

If contract failure passes its empirical tests, that may qualify the theory as an explanation for the existence of nonprofit organizations but not necessarily as a justification for *preferential subsidy* for these organizations. Hansmann has doubts on that score (chapter 2), but James (chapter 22) argues that one element of contract failure theory—the difficulty of monitoring for-profit performance—helps justify choosing nonprofits rather than for-profits as the objects of any subsidizing that is to take place (apparently including tax subsidy). James states that government, viewed as "one large donor with the power to set certain basic contractual terms," finds it easier to monitor nonprofits than for-profits (and may also regard nonprofits as politically safer objects of subsidization).

Even as applied to nongovernmental donors and consumers, the contract failure theory helps build the case for subsidization of nonprofits, by suggesting their comparative advantage in the production of certain goods and service. An alternative economic justification for subsidy is given by Krashinsky (1984), who suggests that "transactions costs" restrict the government in the direct provision of services. Other, noneconomic claims on behalf of nonprofit organizations, as compared to for-profits, point in the same direction: that the associational and participatory aspects of nonprofits contribute to the building of community life (Milofsky 1979); that the rendering of service to others meets important socioemotional needs, including the perception of self-worth; that the nonprofit setting is hospitable to "professional ideology and practice" and fosters professional self-regulation (Majone 1980); that, from the perspective of moral philosophy, there is intrinsic merit in voluntary associational activity for public purposes (Gamwell 1984); and an efficiency claim, involving the ability of nonprofits to deploy voluntary labor (see chapter 22 in this volume).[20] Without rehearsing or analyzing the counterarguments to these claims, I simply note that in many situations there are plausible grounds for relying on nonprofits rather than for-profits—and therefore for directing subsidies to nonprofits rather than to for-profits where some sort of subsidization is desirable.

An alternative rationale for subsidizing nonprofit organizations instead of for-profit organizations—one not based on the comparative advantage of nonprofits—has to do with the capital formation needs of both types of organizations. Hansmann (1981b) notes that the legal prohibition on the distribution of earnings by nonprofits effectively precludes them from issuing equity stock as a way of acquiring capital, and he suggests that in a very crude way the exemption of nonprofits from corporate income tax makes up for this disadvantage by permitting nonprofits to expand with untaxed retained earnings.

If a Subsidy for Nonprofits, Why Through the Tax System? We have, then, several alternate rationales for subsidizing nonprofit organizations, but, for the most part, they are not specifically tied to tax exemption or deductibility. In the search for a support or subsidy rationale for these tax provisions, we encounter, at this point, the contention that, granting the wisdom of subsidization, doing it through the tax system is a mistake (Surrey 1973). Tax subsidies, it is contended, are cumbersome (because it is difficult to pinpoint preferred objects of governmental aid through tax allowance systems), inefficient (because the government may lose more in revenue than is realized in subsidy dollars), inequitable (because of the allocational power they give to higher-income taxpayers), and immovable (because it is harder to amend tax laws than to delete subsidies from appropriations bills).

Postponing the equity point to the next section, we note

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ism precluding effective pursuit of common goals; he quotes John Gardner on the danger of letting the *pluribus* crowd out the *unum* in "E pluribus unum."

[19] Early efforts to test the theory empirically have been made by Permut (1981) and by James Newton, whose work in progress examines consumer choice between nonprofits and for-profits in the child-care area.

[20] The theories mentioned here and in the nonprofit-government comparison do not exhaust the list of possible explanations of the origins and scope of America's third sector: for example, theories grounded in religion (Payton 1984), business history (chapter 1 in this volume), "national character" (DiMaggio 1983), or state expansion (DiMaggio 1983). In the text I have referred only to theories that explain the frequent *preference* for nonprofit as compared to government or business entities.

that, whatever the strength of these laments for tax subsidy in general, there is reason to regard them as less accurate or less serious when directed to subsidies for charity. Thus, with respect to efficiency, although early research indicated that, in aggregate effect, the charitable deduction cost the federal treasury more than the charities gained, subsequent studies by Feldstein and others (all of them summarized in Clotfelter 1985, 56–63) have been widely accepted as demonstrating that the opposite is true—a point to be returned to in our discussion of incentive measures. The defenders of the present system can accept the cumbersomeness point as a strength rather than a weakness, on the ground that the special genius of subsidy via the tax system—instead of governmental pinpointing of subsidy targets—is that it permits decentralized decision making through individual taxpayer choice. (See Hochman and Rodgers 1977, 2–3.) This "calculated anarchy of dispersed initiative, individuality and variety" (Brewster 1965) is consistent with the pluralism the nonprofit sector is valued for promoting.[21] As to the immovability point, its accuracy is in question: perhaps sacred-cow direct appropriations become just as politically imbedded as do tax law provisions, especially in an era of constant tax reform. Moreover, immovability can be defended as a way of buffering the process of individual, idiosyncratic charitable allocations, by subsidizing all of it despite shifts in legislative passions or prejudices.

Assuming that an alternative to direct appropriations is sought for subsidizing of nonprofits, the tax system is not the only option. In a dramatic challenge to the present arrangements, for example, Brannon and Strnad (1977) propose that we consider scrapping, in large part, the subsidization of contributors through tax allowances in favor of a client payment subsidy approach: the government gives vouchers, scholarships, and other forms of subsidies to consumers of the goods and services furnished by nonprofit organizations. This strategy is advanced as a way not only to avoid the equity problems associated with tax deductions but also to moderate various evils flowing from the tax system's subsidization of contributors rather than clients: the programmatic control that large contributors are said to have on some donees (particularly universities); the bizarre allocations that one finds, for example, in the health research field as a result of the mass marketing of some disease charities; and the gross escalation of art prices as a result of excessive tax valuations.

A rich array of empirical, analytical, and normative issues is raised by the Brannon and Strnad proposal (as the authors acknowledge). By way of brief example: What impact would the client payment subsidy system have on the behavior of nonprofit health, education, and welfare organizations now required more than before to market their services to consumers? Would the process of fixing the level of client payments, subject to budget constraints, require the government to make allocational choices, among nonprofit industries and among types of organizations within those industries, that are distinguishable from the choices that have to be made in a direct appropriation system? And who are the clients to receive subsidies in a field like health research? Not the sick people themselves, Brannon and Strnad say, but perhaps disease organizations selected by "a vote of certified M.D.s" (p. 2378). Issues such as these deserve but have not yet received close study.

If Subsidy through the Tax System, Is the Present Method Appropriate? If one resolves these issues in favor of tax assistance as a way of subsidizing nonprofits, the question remains: is the *present* tax system the best approach? Most of the argument under this heading focuses on income and estate tax deductibility. Apart from its efficiency aspects, already discussed, the deduction has been attacked on distributional grounds. These criticisms, and proposals that the deduction be replaced by a tax credit, matching grant, or other allowance not tied to a donor's tax bracket, will be summarized in the equity discussion below.

The debate over the charitable deduction involves not only distributive consequences but also the rationale for selecting this particular form of tax assistance. We have already discussed nonsubsidy rationales; there are also a variety of subsidy theories to choose from. Bittker (1972) considers, as one of several ways of looking at the charitable deduction, that it may function as an award to the donor for a deed highly prized by the society. McConnell (1976) views the deduction as an "alternative tax" (not to be confused with the "alternative minimum tax" imposed under the present code): in effect, both the tax that is collected and the tax that is forgiven as a result of the charitable deduction represent taxes paid, but the latter component is one that the taxpayer is permitted to direct to a chosen public interest activity, in place of activities selected by the central government.

These deductibility theories point to additional research needs. In the absence of sufficient data and analysis relating to these and other issues, this chapter cannot complete the search for an overall rationale for tax exemption and deductibility. Some rationale questions remain, however, directed not to nonprofit tax treatment as a whole but to the differential *coverage* of that treatment—differential as to subject matter and as to type of nonprofit instrumentality.

If the Present Method Is Appropriate, Are Its Distinctions Defensible? As to subject matter, and returning to the four rings of table 5.1, what explains the extra subsidy (if subsidy is what it is) that flows to Rings II–IV, as compared to Ring I? Possible explanatory distinctions have been mentioned: public service versus mutual benefit; public or collective goods versus private goods. How well do the facts fit these distinctions? Weisbrod (1980) has constructed an empirical test for the collective-private goods distinction, based on the ratio between gift support (suggesting collective) and other revenues (suggesting private). One cannot be confident, however, that contributions support is a reliable proxy for public goods provision. Parental contributions to a private school may be a more or less explicitly constructed tuition substitute (Stewart 1973), and alumni contributions may be a form of deferred repayment of prior benefits received (Hansmann 1980). Contributions to the performing arts institutions can be looked upon as a way of charging higher prices to richer patrons without dislocating the explicit price schedule (Hansmann 1981a).

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[21] The property tax exemption, James and Rose-Ackerman have in effect argued (1985, 92–93), presents a special case of cumbersomeness. They say that a general real property tax exemption may be too broad a subsidy mechanism if the social objective is to subsidize the costs of a particular geographical location that itself confers public benefits. "This . . . is an argument for subsidizing land rent, not for a general tax exemption that includes real property."

The past twenty-five years have seen a fairly steady expansion in the nonprofit activities regarded as on the public interest or public goods side of the Ring I versus Rings II–IV boundary. Congress has moved some organizations over the line—Olympic support organizations, societies for prevention of cruelty to animals—by including them in §501(c)(3). A 1960 Treasury regulation placed organizations that combat discrimination and "community deterioration" in the charmed circle (Reg. §§1.501(c)(3)–1(d)(2)). And a series of individual Treasury rulings and court decisions has given the same treatment to a variety of organizations that might earlier have had some sort of Ring I status, including voter education and registration projects (in a private letter ruling issued in 1961), organizations investing in private businesses located in poor communities (Rev. Rul. 74–587, 1974–2 Cum. Bull. 162), and health maintenance organizations organized on a membership basis (Hopkins 1983, 94).[22] For reasons that may or may not have much to do with public interest or public goods theory and that have not been closely examined, Congress has picked some organizations lying within Ring I and, without moving them out of the ring, has declared them eligible to receive deductible contributions: veterans' organizations, fraternal lodges insofar as they carry on charitable activities, and nonprofit cemetery companies (§§170(c)(3),(4),(5), I.R.C.).

Despite apparent departures, one can detect a fairly consistent adherence to principle in the federal tax system's assignment of organizations to what we have called Rings I and II–IV. It is much harder to discern the logic of the criteria for exemption from state property tax laws. As I suggested when introducing table 5.2, the states vary widely in their use of descriptive adjectives. Even within given states the theory behind the distinctions is not always evident: scholars, for example, have been puzzled at the New York courts' restrictive interpretation of "education" for property tax exemption purposes (Swords 1981, 168–74). A comprehensive examination of the state criteria, and the sense that can be made of them, remains to be done.

Some uncharted territory—regarding the criteria for exemption and deductibility—remains in the federal field as well. For example, what are the implications of the public interest or public goods rationales—or of the tax-base-defining rationale—for the tax treatment of the following?

1. Groups whose purposes are predominately thought to be antisocial but that have explicit public interest goals. The Ku Klux Klan and the Communist party are frequently cited but little studied illustrations.[23] The charitable trust law doctrine that charities may not pursue purposes that violate "public policy"—a doctrine invoked by the Supreme Court to deny 501(c)(3) status to a racially discriminatory university (*Bob Jones University* v. *United States*, 461 U.S. 574 [1983])—can be invoked to deny exemption in these cases, but the possible impact of this doctrine on the heterodoxy of the nonprofit sector has caused some concern (Simon, Powers, & Gunnemann 1972, 152–53, and see below).

2. Organizations whose goals are regarded as hopelessly unrealistic or scientifically impossible, or whose programs do not seem destined to succeed. In the mid-1970s the IRS denied exempt status to two environmental litigation groups on the ground, among others, that it was "not clear that the overall effect of the litigation will be beneficial to the area," and the IRS questioned a third applicant: "Are the consequences of your legal activity clearly predictable and obviously beneficial to the community affected?" (Sowles 1980). How would the IRS (or the courts) handle an exemption application from the Flat Earth Society or from a group dedicated to building a perpetual motion machine or communicating with the dead?

Without pausing to explore further the implications of various exemption and deductibility rationales for *subject matter* coverage, we turn to a second coverage issue—that of *types of organization* and, specifically, the question of the distinction among Rings II (public charities), III (operating foundations), and IV (nonoperating foundations). To some extent, the special restrictions on the foundation categories are informed by overall exemption rationales, of either the tax-base-defining or the support-subsidy variety. Thus, language found in the legislative history of the 1969 Tax Reform Act—or the earlier legislation of 1950, 1954 and 1964 that created a precedent for treating nonfoundation charities more favorably than foundations—refers to the greater degree of fiscal abuse thought to inhabit the foundation world (Bittker 1973), or to the greater degree of power or influence over governmental and business institutions (Simon 1978), or to the foundations as repositories of private, "nonaccountable," and usually donor-controlled wealth (Karl & Katz 1981; Simon 1969). Each of these grievances (to be discussed below) contributed to the climate that led to "third-class charity" treatment for foundations, although, as Bittker (1973) makes clear, none of these charges received adequate empirical and analytical study. With varying degrees of difficulty, one can connect these grievances either to a tax-base-defining rationale (for example, because self-serving fiscal benefits add up to "consumption" and therefore point toward taxability) or to a public interest or public goods subsidy rationale (for example, because fiscal self-dealing negates a public benefit).

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[22] As a result of giving §501(c)(3) status to groups that also fall in the Ring I social welfare category [§501(c)(4)], the coverage of these sections is quite similar except for the lobbying restrictions imposed on the latter category (Hopkins 1983, 274–75).

[23] Exemption was denied to "Communist-controlled organizations" by the Internal Security Act of 1950 (64 Stat. 997; 50 U.S.C. 790(b)); see Hopkins (1983, 355).

There were other objections to foundations that more directly invoked a subsidy rationale: quantitative and qualitative complaints about the role of the foundation in creating public goods and services. On the *quantitative* front, it was contended that a dollar given to a foundation produced a direct charitable benefit that was too little and too late compared to a dollar given to a Ring II entity.

"Too little": the yield from foundation endowments, or the payout of those yields, was said to be inferior. Even for years before the 1969 Tax Reform Act (which forced a minimum level of annual payout [§4942, I.R.C.]), the available data did not support this complaint (Simon 1969). A major study of foundation fiscal practices being conducted (as of early 1986) by the Council on Foundations should throw new light on the "too little" story.

"Too late": it was assumed that gifts to foundations become part of endowment,[24] emerging only slowly as income grants to public charities, whereas a gift to a public charity is deployed at once for operational use. In economic terms, to be sure, there is no difference between X dollars given to public charities now and X dollars given to a foundation to be paid out to those charities over time. But from the perspective of hard-pressed human service or cultural institutions confronting an ocean of demand, current cash flow is critical and may not be obtainable in the face of borrowing constraints. Some gifts to conduit-type foundations, however, *are* paid out currently. Moreover, even direct gifts to public charities are not always disbursed currently; they may be locked up as part of the endowment funds of the college, church, hospital, or other recipient because of donor instruction or institutional policy. This is particularly true for large-scale gifts (often of appreciated property) made by the wealthiest donors—the very kinds of gifts that are likely to flow to foundations if not given to public charities. In short, public charities may accumulate their funds, and foundations may disburse at once, contrary to the "too late" assumptions. These and other aspects of the "too late" problem could use more empirical scrutiny.

Legislative objections to the foundations' production of public goods and services were not only quantitative but *qualitative*. Some critics objected to what they perceived as an eastern establishment bias, others to a radical hue, still others to "esoteric" grants (that is how the late Rep. Wright Patman, a leading critic, characterized some of his favorite targets, such as Bollingen Foundation support for study of Bosnian tombstones).[25] A more general qualitative concern seemed to involve "a judgment that publicly supported charities satisfy more pressing social needs than private charities, or that public support constitutes an informal referendum conferring an endorsement on public charities that private charities have not elicited" (Bittker 1973, 143). From a variety of perspectives, therefore, the "value added" by foundations was reckoned to be insufficient to justify "first-class" tax treatment. Other foundation appraisers have struck a more favorable trial balance (chapter 20 in this volume). The task of attempting a systematic analysis of the value-added question is another (and exceedingly difficult) task on the nonprofit research agenda.

As of mid-1984, despite the absence of thoroughgoing research on either the quantitative or the qualitative aspects of foundation performance, there was some evidence that congressional concern on these points had receded. In the Tax Reform Act of 1984, Congress deleted or moderated four provisions enacted in 1969 or earlier that disfavored private nonoperating (Ring IV) foundations:

1. The percentage of adjusted gross income that an individual can deduct for contributions to these foundations (in the form of cash) was increased from 20 percent to 30 percent, as compared to 50 percent for cash gifts to public charities (§170(b)(1)(B)(i)).
2. Individuals giving to these foundations in excess of percentage limitations were given the right, previously denied, to carry over the excess into five succeeding years (§§170(b)(1)(B), (D)(ii)).
3. The excise tax on foundation investment income was reduced from 2 percent to 1 percent for foundations making distributions that exceeded the legally required payout figure by an amount equal to the 1 percent tax reduction (§4940(e)).
4. Perhaps most important, Congress partially repealed the 1969 rule sharply distinguishing between foundations and public charities with respect to gifts of appreciated property; under that rule a taxpayer could deduct the full market value when giving to a public charity but could deduct only 60 percent of the appreciation when giving to a nonoperating foundation unless the foundation quickly "passed through" the gift to public charities. The 1984 legislation treats the foundation as favorably as the public charity when the gift to the foundation consists of publicly traded stock not representing a major interest in the company (§170(e)(5)).

The original (pre-1984) enactment of these four provisions—as compared to the *regulatory* legislation controlling various aspects of foundation behavior (self-dealing, and so on)—was less likely to have been motivated by particular "abuse" concerns and more likely to have been informed by general doubts about the quantitative and qualitative performance of foundations. What is notable about the 1984 modification of these provisions, therefore, is that it appears to reflect a judgment that the support-subsidy rationales undergirding exemption and deductibility for charities in general, whatever these rationales may be, also justify, in almost equal measure, exemption and deductibility for the Ring IV foundations. True, these foundations were still subject to regulatory measures significantly more stringent than those imposed on public (Ring II) charities, but the 1984 narrowing of the gap with respect to the nonregulatory restrictions could be considered to have moved foundations at least from third-class to second-class status.

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[24] With very few exceptions, foundations do not receive their funds as true legal endowments—that is, funds burdened by a restriction on expenditure of capital—but many foundations (and most big ones) treat their funds that way.

[25] Bittker (1973, 158–59) points out that similar criticism of "esoteric" tombstone research could have been directed at public charities, such as universities, churches, art galleries, historical societies, and the D.A.R.

The Support Function in Practice: Effects of Tax Relief

We turn from a look at the rationales for tax exemption and deductibility to an examination of impact: what support for the nonprofit sector do these federal and state tax blessings in fact provide? We start with the impact of present law and then briefly consider change proposals.

Consequences of Present Law

Superficially, it would appear that the impact of federal or state tax *exemption* is more readily discernible than the impact of income or estate tax *deductibility*, for the latter requires a difficult estimate of incentive effects. It turns out, however, that exemption-effect calculations are not straightforward either—which probably accounts for the paucity of estimates on this impact question.

Exemption under Federal Income Tax. If we try to calculate the effect of exemption of nonprofits under the federal income tax, we can obtain detailed revenue figures from each organization filing an information return (Forms 990 or 990–PF), and aggregate estimates have been made from this and other data that seek to take account of organizations not required to file—churches and public charities with less than $25,000 in revenues. One study estimates 1980 revenues for charitable organizations (Rings II–IV) at $129 billion (chapter 4 in this volume). In order to get closer to a taxable income figure, we subtract philanthropic contributions (but not government grants, which more nearly represent payment for services), and the result is $76 billion. But how much of this nondonative revenue represents taxable income? As already mentioned, Bittker and Rahdert (1976) have written about the difficulties in determining what parts of a nonprofit's expenditures should offset revenue to produce taxable income. Moreover, even if we had clearer guidance about how to prepare a putative tax bill, the aggregate expenditure information we have is not satisfactory, for it has been put together from a set of sources different from those that generate revenue numbers (chapter 4 in this volume).

The resulting difficulties are demonstrated by examining the Hodgkinson and Weitzman (1984, 36) data on "total use of resources" for what are, roughly speaking, our Rings II–IV groups in 1980. The known expenditures uncovered by the authors amount to $137.5 billion, which is $22.4 billion less than revenue estimated from other sources at $159.9 billion (somewhat higher than the Rudney estimate in chapter 4). If the $22.4 billion were surplus, that might be taxable income (if we knew how to define it); if we then applied conventional corporate tax rates and made certain assumptions about the corporate tax brackets into which the nonprofits fall,[26] we might end up with a forgiven-tax figure of about $10 billion for 1980. But Hodgkinson and Weitzman have not been able to characterize the $22.4 billion figure as surplus. (As surplus, it would represent a return on "sales" of about 15 percent.) Instead, this figure is "a residual account" which "includes funds for which there is no information about their designated use, and errors of estimation"; it is, in short, a balancing entry.

Although we are bereft of usable data, it seems fair to offer this generalization about the impact of income tax exemption: if we make what strikes me as the reasonable assumptions that (1) in the absence of exemption, a nonprofit would be allowed an offset for its program and administrative expenditures (as its cost of doing business), and (2) after deducting these expenditures, most nonprofits would show very little surplus or profit, then it follows that the amount of forgiven tax—and therefore the amount of this type of support provided to nonprofits—is quite minimal.[27]

Exemption from State Property Tax. The minimal-support generalization is probably not applicable to the state property tax exemption. Although, as we have noted, the theory of property taxation might exclude nonprofit holdings from the base even in the absence of an exemption, that does not mean that state and local governments would act upon that theory and fail to tax a nonprofit deprived of exemption. Accordingly, the property tax exemption offers a great deal more than "quite minimal" support to those nonprofits that own real estate and are eligible for the exemption. To put numbers on this statement, however, is another matter. Although Rudney in chapter 4 of this volume provides estimates of the total assets held by charitable organizations, it is not broken down by type of asset; nor does the IRS publish such information (Hodgkinson & Weitzman 1984, 40). Local governments have offered estimates of the value of tax-exempt property, and some aggregate figures have been set forth on the basis of such estimates (Balk 1971), but the local figures often fail to distinguish between property owned by nonprofits, on the one hand, and property owned by governmental bodies or other exempt holders, on the other hand. (This is not true, however, for Swords [1981] on New York State.) Moreover, all estimates of the value of exempt property are subject to serious cavils: such property is not subject to regular appraisal; it is more difficult to appraise because it so rarely resembles conventional commercial or residential property. The foregoing factors make it easy for governmental officials to indulge an understandable tendency to make the losses to the state or local treasury look as large as possible.

Federal Income and Estate Tax Deductibility. When we go from exemption to federal income and estate tax deductibility, we encounter a different challenge. Here, the amount of deductions is calculated by the IRS with reasonable accuracy, and fairly solid estimates can be derived therefrom of the taxes saved by contributors. For example, in 1983 the deductions amounted to approximately $36 billion (American Association . . . 1985), resulting in an estimated tax-saving of $10 billion for fiscal 1983. How much of this $10 billion represented nonprofit-sector support that is attributable to tax deductibility, however, depends on how much the taxpayers contributed to charity in relation to what they would have given in the absence of deductibility. The "price elasticity of giving" enables us to determine this amount; it tells us how much increased giving is induced by a given reduction in the "price" of the gift (through tax savings resulting from deductions). Feldstein's research for the Filer Commission (Commission . . . 1975, 129) presented widely accepted evidence of price elasticities between −1.15 and −1.29, meaning that each dollar of tax saved by taxpayers results in $1.15 to $1.29 in increased giving. Jencks (chapter 18 in this volume) reports that several studies, using different approaches, agree on elasticities between −1.0 and −1.5, or "on the order of −1.25." Multiplying this figure by the $10 billion in tax savings for fiscal 1983 (and lumping corporate donors with individuals for want of disaggregated data), one may surmise that charitable organizations received roughly $12.5 billion in support attributable to income tax deductibility in fiscal 1983, at a cost to the Treasury of approximately $10 billion.

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[26] An average rate of 40 percent has been rather arbitrarily assumed. Note, however, the doubt expressed by Bittker and Rahdert (1976) about reliance on corporate tax rates for making this calculation.

[27] Hansmann in chapter 2 in this volume offers a substantially less modest estimate of the amount of profit earned by certain categories of nonprofits.

Information on the support provided by the *estate* tax deduction (or its efficiency) is more difficult to find. We do not have data on how much of the $4.5 billion in bequests received by charities in 1983 had been deducted for federal estate tax purposes, but it is a plausible surmise that most of these bequest dollars came from taxable estates in which a deduction had been taken. Speculating that roughly $4 billion in deductions were involved and that the average marginal estate tax bracket was 50 percent, and splitting the difference between the estate tax price elasticity estimates of Feldstein (1977) and Boskin (1977)—both of which were greater than one—we come up with a rough guess that in 1983 charities received slightly more than $2 billion in support attributable to estate tax deductibility. Again, the elasticities also tell us that this support is efficient in terms of revenue losses.

Consequences of Proposed Changes

From time to time, state and local government officials talk about eliminating the charitable property tax deduction, and occasionally a state (such as New York in 1971) cuts back on the scope of the exemption, permitting localities to place groups back on the tax rolls (Swords 1981). And although there has been no similar talk about ending the federal income tax exemption for charities, inroads were made in this exemption when taxes were imposed on unrelated business income, on foundation investment income, and on political organization income (Bittker & Rahdert 1976). Moreover, Hansmann (1985, 12) contends that the 1984 Treasury proposals to repeal the exemption for nonprofit insurance companies, coupled with the proposed repeal of some other exemptions (interest on municipal bonds that benefit tax-exempt institutions and credit unions), represent a "serious sign of trouble for the corporate tax exemption for nonprofits." The tax reform bill passed by the House of Representatives in December 1985 followed up on the Treasury's insurance proposal: it would repeal tax-exempt status for nonprofit organizations "providing commercial-type insurance," including Blue Cross and Blue Shield (with some exceptions) and TIAA-CREF, the major provider of teacher pensions.[28] Should this provision become law or a broader repeal of federal income tax or state property tax exemptions be enacted, our earlier discussion of support levels points to methods—and difficulties—of calculating the consequences for nonprofits and suggests that repeal of property tax exemption may be more injurious than repeal of income tax exemption.

In recent years, however, most of the movement for change in tax support for the nonprofit sector has focused on deductibility under the federal income tax and (to a lesser extent) the estate tax. The major estate tax proposal came in the mid-1970s: to limit the charitable deduction to 50 percent of the gross estate (criticized in Bittker 1976). On the basis of 1969 data, Boskin estimated that this change would cause testators to cut out half of the 1969 level of testamentary charitable giving ($338 million—about a tenth of the 1983 level), with only a $43 million revenue gain (Commission . . . 1975, 151).

The traffic in proposals concerning the income tax deduction has been prolific, some of it aimed at increasing support for charities, and some intended to achieve various tax reform objectives that are probably inconsistent with increased charitable support.

Federal Tax Proposals to Induce Higher Giving. Increased support proposals in recent years have included these measures, listed here with no attempt to quantify the consequences:

- Providing a 200 percent or 150 percent deduction, respectively, for low- and middle-income givers, recommended by the Filer Commission in 1975 (Commission . . . 1975, 141–42).
- Substitution of a flat tax *credit* for the present deduction (for example, a credit against tax of 30 percent or 50 percent of each contributed dollar), or an optional credit to be used in place of the deduction (Commission . . . 1975, 127–33). While sometimes advocated as a way of overcoming the regressive tilt of the deduction, a credit at these levels would also have the effect of increasing total giving. The commission, however, did not endorse a credit as a substitute for the deduction because of its

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[28] §1012 of the House bill, adding §501(m) of the code. The Ways and Means Committee report states that this insurance activity is "so inherently commercial that tax-exempt status is inappropriate" and that it unfairly competes with commercial companies (House Report 99–426, 664).

allocational effect: under a 30 percent credit, giving to religion would increase, but giving to education and to hospitals—"among the financially hardest pressed of nonprofit organizations"—would drop substantially.

- Permitting corporations to take a 10 percent tax credit on top of charitable deductions (Commission . . . 1975, 155).
- Permitting artists who contribute their own creations to a museum to deduct at market value, as compared to the present-law deduction limited to the cost of materials (170(e), 1221(3)). This change would obviously increase the flow of art works to museums (see Frankel 1979), but no dollar estimates are available. The change might also result in additional valuation problems, as artists sought generous deductions for works that had never been the subject of a bargained-for valuation.[29]
- Easing restrictions on giving to foundations beyond the liberalizations enacted in 1984 (referred to above). New steps would permit donors to Ring IV organizations to deduct as high a percentage of adjusted gross income as donors to Rings II and III organizations, repeal the excise tax on foundation investment income, and eliminate some or all of the several regulatory restrictions imposed on Rings III–IV but not Ring II organizations.[30]

Federal Tax Proposals with Negative Effects on Giving. Several other recent or pending proposals, although not aimed at altering the level of giving to charities, could be expected to have a negative effect. The proposals listed below were part of various "flat," "fair," and/or "simplified" tax proposals that were being debated in 1984 and 1985, some of which were adopted by the House of Representatives in December 1985. They are briefly summarized here because they typify initiatives that can be expected to arise in the modern tax reform era and that, if enacted, would affect support levels for the nonprofit sector.

1. Tax reform proposals submitted by President Reagan in May 1985:

- Reduction of marginal tax rates, with the top rate declining from 50 percent to 38 percent (in the December 1985 House bill). Because a rate reduction increases the "price" of giving, this change by itself (and even giving effect to the increased after-tax income made available) is reckoned to have more of an impact on annual giving than any other changes listed below.
- Elimination of the deduction for state and local taxes. This change would make it unrewarding for many taxpayers to itemize their deductions—it is estimated that the nonitemizing percentage of taxpayers would rise from 62 percent to 75 percent—thus reducing the numbers of persons with a tax factor in their giving decisions. A decline in itemizers would not, however, have an effect on charitable giving if *non*itemizers were permitted to deduct their gifts—the subject of the next item.
- Repeal of the legislation that, by the year of full phase-in, 1986, would have allowed *non*itemizing taxpayers to claim charitable deductions on an equal footing with itemizers.

2. Tax reform proposals made by the Treasury in November 1984 not included in the above list:

- Denying donors the ability to deduct the market value of appreciated property gifts and permitting them to deduct only the original cost adjusted for inflation. This change was estimated to result in a significant decline in giving to higher education and arts institutions, the principal recipients of appreciated property gifts.
- If the foregoing provision was *not* enacted, requiring—as a substitute measure—that the amount of appreciation deducted by a property donor be designated a "tax preference item," thus subjecting it to a possible 20 to 25 percent "alternative minimum tax," with the impact falling mainly on educational and cultural institutions. The House of Representatives passed a modified version of this proposal in December 1985 as part of the tax reform bill.
- Imposing a floor of 2 percent of adjusted gross income, below which an individual taxpayer could not deduct contributions.[31]

Economists who studied the 1984–85 proposals have agreed on the general (downward) direction of the giving changes that would result and on their nontrivial dimensions (Clotfelter 1985; Lindsey 1985; Rudney & Auten 1985), but they have disagreed about magnitudes.[32] These discrepancies derived in part from the fact that even the most sophisticated econometric work has difficulty accounting for new contexts. For example, will price elasticity estimates based on 1981 or an earlier period apply to the philanthropic environment of the late 1980s? Will cross-sectional data comparing itemizers with nonitemizers at a single point in time predict what happens, over time, if and when nonitemizers lose their ability to take charitable deductions?

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[29] In 1984 Congress required the Treasury to issue new appraisal and substantiation rules to cope with art valuation problems (Public Law 98–369, §155(a)(1)–(6)).

[30] The impact of existing law on giving to foundations is being considered as part of a study of the trends in the birth, growth, and death of foundations, and of the determinants of these trends, launched in 1983 by the Yale Program on Non-Profit Organizations and the Council on Foundations, scheduled for completion in 1986.

[31] The one Treasury recommendation in the charitable field that cuts in the other direction is a recommendation that the 50 percent ceiling on the amount of adjusted gross income that can be given to charity be eliminated. This change was estimated, however, to induce only modest increases in charitable giving

[32] These studies were discussed at a February 1985 Brookings Institution conference. A comparison of the three studies appears in Zimmerman (1985).

What reduces confidence in econometric predictions as one moves from context to context is that the elasticities and other statistical formulations are not informed by a body of behavioral learning on the dynamics of charitable giving. Although psychologists, social psychologists, and sociologists have developed a considerable body of research on individual helping behavior and altruism (reviewed in Gonzalez & Tetlock 1980), no comparable corpus addresses the determinants of money or labor contributions to nonprofit organizations. Survey research has been undertaken that asks respondents to explain their donative patterns (see Jencks, chapter 15 in this volume, and a forthcoming study by White [1986]), but neither the academy nor the fund-raising profession and industry has mounted a full-fledged effort to develop testable hypotheses regarding the factors shaping donative behavior and to test these theories empirically with simulated or naturally occurring data. Scholars and fund-raisers alike speculate about such (often overlapping) factors as identification with others, guilt, redistributional passion, religious belief and/or obedience, social or business pressures, self-esteem, feelings of indebtedness, quest for power over others, and desire to obtain pecuniary or educational advantage for family members—as well as less individually oriented behavioral explanations that invoke cultural norms or social mechanisms such as "network matching" (Boorman & Levitt 1981).[33] The mix of possible motives and influences is staggering, and some academically trained observers wonder if the subject is, in fact, researchable. Yet it seems odd that an industry that currently "sells" $75 billion of charitable wares per annum to individual and institutional donors, and hopes to do a great deal better, should go about its work using such a slender knowledge base. No other industry of remotely comparable size and complexity conducts its business relying on such a high ratio of art to science.

Until the nature of philanthropic giving is studied with more energy, system, and imagination, econometric predictions will have to be received with caution, and, indeed, the more general question of the efficiency of the support function of nonprofit tax policy will remain in at least partial darkness.

THE EQUITY FUNCTION OF NONPROFIT TAX LAW

Service to a wide spectrum of the public—including its least advantaged members—is a venerable and transcendent theme in the history of charity. It has roots in ancient Egypt (Gladstone 1982), in the Old and New Testaments (Isaiah 61:1; Luke 4:17), and in the 1601 English statute that still dominates Anglo-American charity law (Statute of Charitable Uses, 43 Eliz. I ch. 4 [1601]; Gladstone 1982, 56–57). It has long been urged that the tax treatment of nonprofits reinforce this notion of "equity" (as the word is often used in this context), or at least not undermine it. These equity claims, however, sometimes seem to contravene other values that charity seeks to serve—such as the encouragement, in the name of pluralism, of new cultural traditions and the preservation of old ones—interests that do not have high priority for many disadvantaged citizens.

The tax policy questions that flow from these and other value clashes involving equity fall into four broad categories, of which the first most directly poses the historic equity issue and the other three are corollary.

1. How much should nonprofit tax policy insist on service to the poor, or, more generally, how much must it incorporate a redistributional ethic? (Redistribution, of course, need not benefit only the poor; it takes place, as Bittker has pointed out, when a middle-class art lover visits the Getty Museum.)
2. How much private benefit may the donor derive from his or her gift? This question relates to the first because a high degree of gain to an affluent donor may dilute any redistributional thrust of the gift.
3. How much allocative power should donors be permitted to wield? Here, the allocative capacity per se is the subject of equity concern, apart from the redistributional impact of the gift itself (question 1), and apart from any other aspects of private benefit (question 2).
4. To what extent is discrimination or preference based on the race, gender, religion, or ethnicity of the beneficiaries acceptable? This question may but need not overlap with the redistributional issue under question 1.

This discussion focuses on aspects of each topic that have received research attention.

The Redistributional Issue

Those who seek an explicit link between the legal criteria for tax-blessed charitable activity and assistance to the poor will only occasionally be able to find it. Even assuming that redistribution is a sine qua non of the tax law, the ways of effecting it in an economy as complicated as ours cannot be spelled out with sufficient precision to become a legal standard. Indeed, it is at least difficult and perhaps impossible to determine the redistributional impact of many or most forms of charitable endeavor. The one author who has tried, in a prefatory manner, to trace the degree to which charity results in a downward shift of income and wealth, concluded that "the redistributional effects of philanthropy are incalculable in the most literal sense of the word" (Schenkkan 1974, 50).[34] Moreover, the methods employed by both governments and nonprofit institutions to address poverty have necessarily become more sophisticated and indirect as the social order becomes more complex and also as charitable agencies, over the centuries, have moved away from almsgiving remedies.[35]

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[33] Some of these factors, along with class, ethnic, and other background variables, are discussed in chapter 18 of this volume. A comprehensive endeavor to speculate on many of these factors, against a background of philosophical and religious thought, appears in Payton (1984).

[34] Schenkkan's essay sets forth an outline for further research on this subject that merits follow-up by scholars interested in the subject of distributive justice or philanthropy, or both.

In any event, it is not at all clear that legislative bodies, federal or state, American or British, have adopted the assumption of the previous paragraph: that redistribution is a sine qua non of charitable exemption and deductibility. The British Parliament continued the charitable exemption when the income tax was reintroduced in 1842 with no effort to exclude "schools for the sons of gentlemen," and these schools had recently been determined to be charitable for nontax purposes (Gladstone 1982, 58). Congress has never imposed redistributional requirements. State court decisions during the period 1927–62 in Connecticut, Ohio, and Pennsylvania, interpreting the word *charitable* in property tax exemption statutes, declared the American counterparts to "schools for the sons of gentlemen" to be ineligible for property tax exemption because of failure to make an effort, within reasonable financial limits, to include less advantaged students. In Connecticut, however, the legislature amended the exemption statute to restore tax-free status for such schools (Stewart 1973). And in other jurisdictions the word *educational* in an exemption law has not been held to require such redistributional efforts.

In the face of societal complexity and legislative ambiguity, plus uncertainty about the basic rationale for exemption and deductibility, it is little wonder that taxing authorities and courts have not consistently required that claimants of charitable tax status demonstrate service to the poor (Swain 1984; Persons et al. 1977). Educational institutions need not meet such a test under federal law or under many state property tax laws. Treasury regulations once required that hospitals offer free or reduced-cost services, within the limits of financial feasibility, in order to enjoy §501(c)(3) status, but the IRS relaxed this rule in 1969 to require only that, if there is an emergency room, it must be open to all and that patients having third-party financing must not be turned away from the rest of the hospital. (The 1969 change was struck down by a federal district court but upheld by a federal court of appeals, with the Supreme Court then dismissing the case on procedural grounds [Hopkins 1983, 81–82].)

On the other hand, the IRS has required that consumer credit counseling agencies exclusively serve low-income persons if they wish §501(c)(3) status (Hopkins 1983, 82)—a ruling akin to the IRS position on other service agencies that resemble for-profit firms. The IRS appears willing to treat these agencies as charitable only if they distinguish themselves from their commercial counterparts by providing below-cost services (Persons et al. 1977). Somewhere in between is the position taken by the IRS on nursing homes: if they provide housing and health services tailored to the needs of the aged, they meet exemption standards by providing services "at the lowest feasible cost" and by not discharging residents who, after being admitted, thereafter "become unable to pay their regular charges" (Hopkins 1983, 93).

Returning to the less regulated end of the spectrum, cultural institutions (so long as they aim to make artistic works widely available) qualify for §501(c)(3) status without redistributive objection from the IRS. Even though the Tax Court has recited the fact that nonprofit theater groups have "the desire to keep ticket prices at a level which is affordable to most of the community,"[36] the IRS has made no significant effort to ensure that either prices or programs of cultural organizations are designed to attract low-income audiences; nor has an attempt been made to raise this issue in legislative, judicial, or academic forums considering federal tax issues. One sometimes reads in the press, as an argument against state property tax exemption for museums or concert halls in elegant locations, the assertion that they are not accessible to low-income members of the community, but I am not aware of any denials of exemption on such redistributional grounds.

Should such a denial be attempted at a federal or state level, addressed to cultural or educational exemptions, it would surely be met with the objection that modern-day charity, and modern-day charitable tax law, serve other important values (some mentioned at the start of this section). In weighing this objection, one would be cast back to basics: to the search for a rationale for exemption or deductibility, or indeed to even more fundamental issues relating to the primacy of redistributional norms in American law.

The Retained Private Benefit Issue

Although the tax case law, rulings, and literature on the redistributional question are fairly thin—in some contexts it is not even discussed—the issue of private benefit retained by the donor has been more fully ventilated. As a result, something approaching a "bright-line standard" has been developed. On the one hand, the receipt of cash or other directly realizable material benefits—or benefits not readily realizable but nevertheless contractually assured—will disqualify or limit a donor's deduction and can cause a denial or revocation of the recipient organization's exemption.[37] Thus, deductions for theater benefits must be reduced by the market value of the tickets received; gifts for environmental projects that enhance the value of the donor's land are nondeductible; an alumni fund-raising program that promised a priority claim on the best football seats (but no tickets) led to nondeductibility (with the contractual nature of the arrangement playing a major part); and Congress has worked out an elaborate set of rules to preclude donors from retaining economic benefit, at the expense of charity, as a result of making "split interest" gifts—where, for example, the donor retains a life interest or a remainder interest in the donated property (Kurz & Robinson 1977).[38]

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[35] The trend in Great Britain from the seventeenth to the twentieth century is chronicled by Owen (1964); see also chapter 1 in this volume. In the twelfth century, Maimonides anticipated this movement by listing, at the highest level of charitable purity, not alms but loans or gifts that would assist "a poor Jew to put himself on his feet" (Marcus 1938, 364–65).

[36] *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), aff'd 675 F.2d 244 (9th Cir. 1982).

[37] A challenge to the deduction is usually based on the notion that, in whole or part, no true contribution was made; an attack on the exemption is based on the notion that the organization is not "organized and operated exclusively for . . . charitable . . . purposes" or that "net earnings" have "inure[d] to the benefit" of the donor (§501(c)(3)). The exemption rules are treated in Treusch and Sugarman (1983) and Hopkins (1983).

On the other hand, private benefits that are not directly realizable in material terms (or contractually assured) do not count. Deductions are not lost because the donor enjoys memorialization on the front of a building or at a testimonial dinner, enhanced college admission opportunities for the donor's child or business relationships for the donor, hopes for salvation or at least the expectation of perpetual prayers, the shared benefits that come with public goods like parks or cleaner air, or the general expectation that somewhere, somehow, the giver will benefit. ("Cast thy bread upon the waters: for thou shalt find it after many days" [Ecclesiastes 11:1; see Ross 1968].) Nor does the fact that the donor's motives were other than selfless defeat the deduction: neither charitable trust law (Bogert & Bogert 1973, 202) nor charitable tax law (Hopkins 1983) requires subjective altruism, despite the teaching of St. Paul: "And though I bestow all my goods to feed the poor . . . and have not charity, it profiteth me nothing" (1 Corinthians 13:3).

Ignoring motive may be a necessity for the tax system: the search for purity of charitable intention would be an unmanageable task, even ignoring the complications caused by psychoanalytic theory. But the *benefit* rules we have canvassed, even though fairly well set forth in the law and literature, have been subjected to demanding scrutiny by very few writers. One of these (Jones 1985) believes that private benefit to the donor is not the issue; the only pertinent question is whether the *charity* gets a "net benefit" commensurate with the donor's tax deduction. This formulation will be resisted by those who are particularly concerned with redistribution and who see it undermined if the donor comes out ahead, even where the charity does not come out behind. It will also be resisted by those who subscribe to the income-defining rationale for deductibility; the retained donor benefit will seem to represent a form of consumption under the Haig-Simons approach.

The Allocative Power Issue

Under this heading we consider not the way in which material benefits are distributed or the way they are captured by the donor but the fact that the income and estate tax deductibility "permits wealthy citizens to outweigh less-wealthy persons in controlling the disposition of taxable income and wealth and, as a corollary, . . . makes it easier for wealthy citizens to use taxable income or wealth to influence the behavior of others" (Simon 1978, 56). The apparent power imbalance results from the proposition, noted earlier, that, under the present deduction system, the price of giving is lower for an affluent, high-bracket taxpayer than for a poorer one, and that the "after-tax cost of exercising power in the charitable world is cheaper for the rich than the poor" (p. 24).[39] The late Stanley Surrey (1973, 229–30) attacked this process as one that subsidizes the wealthy in a "bizarre upside-down fashion" (see also McDaniel 1977; Good & Wildavsky 1977).

One answer to this challenge lies in the income- and estate-defining rationales. As noted earlier, if they are accepted, the notion of a subsidy drops out and, with it, the claim that the deduction subsidizes the rich. Even apart from the subsidy issue, these theories provide a possible rebuttal to the notion that the deduction reduces the "after-tax cost . . . for the rich": if the donated funds are viewed as never part of the contributor's income subject to taxation, then the after-tax cost is the same for rich and poor. In an earlier essay, however, I suggested that this is an "excessively strenuous application" of these tax-base-defining rationales (Simon 1978, 24*n*42).

Putting aside alternative rationales for deductibility, a dramatic version of the power allocation phenomenon arises in the foundation context: the foundation mechanism enables a wealthy person to make deductible gifts of assets over which the donor and donor's family can maintain long-term dynastic control involving both managerial and dispositive powers. Congressional critics (Select Committee . . . 1962), the U.S. Treasury Department (1965), and scholarly writers (Stone 1977) have all assaulted the donor control phenomenon, although from differing perspectives. This phenomenon may have contributed to "third-class" treatment for foundations in 1969, and in the 1984 Tax Reform Act, Congress singled out non-donor-controlled entities for exemption from two of the restrictions normally imposed on operating (Ring III) foundations (§§4940(d), 4945(d)(4); see table 5.1).

Is dynastic control of foundations significantly different in kind from the more general allocative power that accrues to a wealthy donor as a result of tax deductibility? I have argued that it is not—that "mainly a balance of convenience distinguishes the power of foundation donors from the power of non-foundation donors" (Simon 1978, 18). "In various ways it is simply easier, through the foundation, to achieve personal or dynastic managerial or dispositive power" (p. 17).

My essay then analyzes the more general allocative power phenomenon, asking whether it violates (1) norms of progressive income and estate taxation or (2) principles of equity and fairness against which all legislation should be judged. Under the first heading, the study examines legislative, judicial, and scholarly materials to determine whether "the leveling of dynastic power . . . is a significant goal of tax progressivity," and reaches a negative conclusion (p. 55). Under the second heading, the study acknowledges the nonegalitarian tilt of the deduction system but notes that our society has accepted other forms of class-biased legislation that seem to meet four criteria set forth in the essay. The first of these criteria is advancing an "important affirmative social purpose . . . that benefits the classes of persons who are the 'victims' of the inequality"; the deduction system is thought to meet this test by encouraging large-scale single-source gifts—the kind of philanthropy that appears to promote "individuality and variety" within the nonprofit sector and "the diffusion of power within the larger society" (pp. 62–75). In a subsequent essay, Strnad (1986) lends support to the benefit-the-victims argument: his economic model of subsidy structures leads him to conclude that "the deduction's higher subsidy for high-income individuals may be just a way of insuring economic efficiency and an allocative mechanism that accords with the preferences of *all* voters including lower-income and middle-income people who are not the apparent beneficiaries of the deduction." Strnad thus takes issue with Hochman and Rodgers (1977), who believe that a flat-rate tax credit will come closer than a deduction to achieving such an evenhanded outcome.[40]

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[38] Retained benefit of this kind would also undermine the case for deductibility under the income- or estate-defining rationales discussed earlier, for such retention can be viewed as personal consumption that is unacceptable under these rationales.

[39] The study suggests that, even if the deduction system were replaced by a credit arrangement (discussed above), the allocative power issue would remain, although in muted form.

The other criteria my essay advances relate to the gravity and reversibility of the inequality[41] and to the availability of more egalitarian alternative routes to the same social purpose. Applying the four criteria to the deduction system, the study concludes that it "comes out with passing grades. It seems to present a plausible case for survival in a democratic order" (pp. 84–85).

This analysis of the allocative power problem teems with theoretical propositions and empirical assumptions that require testing and challenge. Unfortunately, there has been no in-depth debate that would call forth such scrutiny.[42]

The Discrimination or Preference Issue

The general debate that has been missing in the allocative power field has been flowering in the discrimination-preference area, triggered by the controversy over the tax status of "segregation academies" in the South (including IRS denial of tax-exempt status and congressional response thereto [Schwarz & Hutton 1984]) and by the prolonged *Bob Jones University* litigation (ending with a Supreme Court denial of exempt status on grounds of racial discrimination [*Bob Jones University* v. *United States*, 461 U.S. 574 (1983)]).

Some of the debate about tax exemption and deductibility for racially discriminatory groups involves the constitutional question whether the acts of an entity enjoying §501(c)(3) status constitute "state action," thus invoking the constraints imposed by the Equal Protection and Due Process Clauses of the Constitution and the implementing provisions of the 1866 Civil Rights Acts. A panel of the federal Court of Appeals so held in the context of a private foundation accused of employment discrimination; a tie vote of the full court defeated an effort to obtain reconsideration by that court (*Jackson* v. *Statler Foundation*, 496 F.2d 623 [2d Cir. 1974]). And a federal district court held that the exemption of investment income earned by a fraternal organization (Ring I on our chart) was a sufficient government benefit to bring the state action doctrine into play and bar racial discrimination (*McGlotten* v. *Connally*, 338 F.Supp. 448 [D.D.C. 1972]). Yet the latter decision has been criticized for the way it has gone about "constitutionalizing" the tax code (Bittker & Kaufman 1972), and the former decision has been condemned for blurring the time-honored distinction between public and private institutions and threatening the autonomy of private nonprofit groups (Judge Henry Friendly's dissent, 496 F.2d at 636). Fears and objections of this kind dissuaded the nonprofit organizations filing briefs in the *Bob Jones* case from seeking a constitutional decision from the Supreme Court.

In point of fact, the IRS attack on the tax status of discriminating organizations and the Supreme Court's treatment of Bob Jones University have employed a *non*constitutional approach based on §501(c)(3), which, the Supreme Court held, incorporates the common law of charity.[43] That law in turn can be said to deny charitable status to racially discriminatory groups on two similar-sounding but significantly different grounds: (1) the doctrine that a charitable gift or trust fails if its terms violate some public policy embodied in the criminal law or otherwise clearly enunciated as a legal norm, and (2) the concept that a charitable body must serve some public purpose and confer a public benefit. The IRS had relied on the first of these approaches in denying exempt status to discriminatory schools (Rev. Rul. 71–447, 1971–2 C.B. 230), and a federal three-judge court came out the same way on the same ground.[44] The Supreme Court's decision in *Bob Jones*, however, seemed to rely on *both* of these approaches, despite the concern of commentators that the second approach opened the door to IRS determinations that unorthodox or unpopular groups do not advance the public purpose and therefore should not enjoy §501(c)(3) treatment (K. Simon 1981; Galston 1981). The first approach, requiring a finding that the challenged activity directly violates some clearly enunciated legal norm, appears to be more narrowly constructed and thus less open to official manipulation. Yet there is a degree of danger in any resort to public policy or public interest criteria for tax exemption, as Justice Powell observed in his *Bob Jones* concurring opinion (103 S.Ct. at 2038–9; see also Simon et al. 1972, 152–53). It is conceivable, if not likely, that these standards could be used to deny tax deductibility to groups favoring homosexual rights or *opposing* (through lawful means) black or women's rights, with grave consequences for the pluralism the nonprofit sector is widely valued for nurturing.

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[40] Zimmerman (1985, 28) suggests that a credit would mitigate the tendency of the tax subsidy system (in its deduction mode) to favor gifts to cultural and higher education institutions that are not "generally targeted on the poor," as compared to religious organizations where "much of the charitable work . . . is devoted to the poor." But Andrews (1972, 354) argues that "the net effect of substituting a credit for a deduction would be to tax some contributors on their contributions while subsidizing others."

[41] The reversibility criterion raises the question of ease of repeal of an inegalitarian measure. The charitable deduction confers what its critics deem disproportionate allocational power on a small fraction of the population (those in higher brackets) and is, therefore, readily reversible by a disapproving majority. In fact, however, the public overwhelmingly favors it (Simon 1978, 84), although, of course, that may be a function of not understanding how it works. This phenomenon is dealt with in detail by Strnad (1986).

[42] Michael Fitts, however, has been preparing a rebuttal of one important part of my essay, which will be published by the Yale Program on Non-Profit Organizations. Among other things, Fitts questions the assumption that encouraging large-scale giving by high-income donors necessarily results in the large-scale *gifts* on which my analysis places a high value.

[43] Although the Court did not use a constitutional avenue to its outcome, it had to consider—and rejected—a constitutional challenge by Bob Jones University, which claimed that denial of tax exemption infringed its free exercise of religion.

These possible outcroppings—and the resistance to them—are one aspect of the unfinished business of the *Bob Jones* case. Another has to do with the treatment of gender discrimination or preferential arrangements that favor minority or disadvantaged groups—the subject of a great deal of landmark litigation outside the tax field (for example, *Regents* v. *Bakke*, 438 U.S. 265 [1978]) but largely unplowed soil in the tax area. Schwarz and Hutton (1984, 657–58) mention some of the pending issues:

> Will a school practicing gender discrimination qualify as "charitable"? What about a church that discriminates on the basis of race or an orthodox Jewish school with no minority enrollment? Does a charitable trust that grants scholarships only to Caucasians violate the public policy standard of *Bob Jones*? What about a foundation that makes scholarship awards only to students of minority races?

The authors report that early returns suggest that the IRS is not opposed to §501(c)(3) status for either the Caucasian-only or the minority-only funds (p. 658). The questions the authors pose, however, will continue to be troublesome for the IRS, the courts, and tax policy scholars.[45]

THE POLICE FUNCTION OF NONPROFIT TAX LAW

The police function involves the federal tax system in an extensive program of regulating the fiduciary behavior of nonprofit trustees, managers, and donors. As we contemplate this central fact, the obvious first question is: why is this function within the jurisdiction of the tax system? Upon a slightly closer look, we ask a second question: why are the foundations (Rings III and IV) regulated so much more rigorously than the public charities (Ring II) or the noncharitable nonprofits (Ring I)?

The Jurisdictional Puzzle

What sharpens the first, jurisdictional question is the contrast with the support and equity functions. These are strongly linked to the definition of charitable activity—and therefore to definitional questions that must be taken into account in granting or denying exempt status—whereas the police function is less closely connected to these questions. To be sure, it can be contended that fiduciary regulation is essential to ensure that a group is "organized and operated exclusively for . . . charitable purposes." Yet Hooper (1985) suggests that this is true only with respect to one of the two main branches of fiduciary duty: the duty of loyalty (to the ultimate charitable beneficiaries and the commands of the charitable charter). With respect to the other fiduciary branch, the duty of care, a fiduciary's negligent and wasteful administration impairs a nonprofit's ability to perform but does not affect its charitable purpose and character[46]—presumably the central concerns of the exemption and deductibility statutes.

Moreover, if one takes into account the availability of alternative regulatory mechanisms (that is, other than the tax system's police function) for handling fiduciary enforcement, questions arise about whether either the duty of loyalty or the duty of care needs IRS policing. Both of these duties are the historic concern of the state courts, successors to the English chancellors in equity who regulated the fiduciary conduct of private trustees; these courts and the state attorneys general, who are the moving parties in fiducia enforcement, have jurisdiction over nonprofits chartered o operating in their territories. The customary response to the suggestion that the tax system yield fiduciary jurisdiction to the states is that many of the state attorneys general are understaffed, inexperienced, or uninterested, or (along with some judges) in thrall to local nonprofit barons. In rebuttal, it has been suggested that some of the states are well equipped to carry out the enforcement function, that there are ways o assisting the other states to improve, and that perhaps " decent regard for the desirable features of federalism" should encourage exploration of these possibilities (Simon 1965, 70).[47]

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[44] *Green* v. *Connally*, 330 F.Supp. 1150 (D.D.C. 1971), *aff'd mem. sub. nom. Coit* v. *Green*, 404 U.S. 997 (1971).

[45] The ability of courts to deal with these matters at all will depend in part on the ability of contesting parties to obtain standing to be heard in court. The Supreme Court held in 1984 that persons cannot complain about IRS policies unless they can show direct personal injury traceable to those policies (*Allen* v. *Wright*, 104 S.Ct. 3315 [1984]).

[46] Paul DiMaggio points out that gross mismanagement could result in such a shortfall in service, or force such a dramatic shift to fee paying clientele, as to alter the character and defeat the purpose of th nonprofit organization.

[47] Some observers have suggested a solution involving neither th IRS nor the states: assigning supervisory responsibility to a speci (non-IRS) unit within the Treasury Department or creating a new, spe cialized federal agency for charitable supervision somewhat on th British model (see Ginsburg et al. 1977; Carson & Hodson, 1973 These proposals and arguments raise both theoretical issues (as to th allocation of regulatory functions within our federal structure) an empirical questions (as to the relative efficacy and capacity of IRS an other federal and state agencies) that await further exploration.

It must be said, however, that there is little movement in the mid-1980s for altering the present IRS-based policing system. Indeed, the foundation legislation of 1969 represented a move toward even greater reliance on the IRS, as the following discussion makes clear.

Policing the Foundations

Although there is no specific code of fiduciary behavior that informs tax policing of Ring I or Ring II organizations—the general "organized and operated exclusively for . . . charitable purposes" language is the global legislation on which IRS and courts rely—the *foundations* operate under a much more detailed set of legislative rules. These rules, referred to in table 5.1, are the following:

1. The "self-dealing" rules (§4941) impose outright prohibitions on certain kinds of transactions between a foundation and its fiduciaries or donors, whether or not the transactions are unfair to the foundation—as compared to the standards applicable to public charities, where the test is fairness: would the transaction have resulted from arms-length bargaining between strangers?
2. The "pay-out" rule (§4942), which requires annual distributions equalling 5 percent of investment assets, can affect fiduciary behavior by inducing foundation managers to make investment assets more productive of current income in order to reach the required distribution level without a forced sale of foundation assets. Public charities operate under no comparable strictures, although an excessively stingy pay-out policy might lead to attack under the "operated exclusively" clause.
3. The "jeopardizing investment" rule (§4944) directly regulates the investment practices of foundation managers. Even though the Treasury regulations call for a "whole portfolio" approach rather than scrutiny of each individual investment (Reg. §53.4944–1(a)(2)), the constraints on speculation or nondiversification are considerably greater than those applying to public charities under the "operated exclusively" clause (Bittker 1973).
4. The "excess business holding" rule (§4943), which effectively precludes foundation or joint foundation-donor control of a business corporation and which will be discussed further below, represents another form of fiduciary regulation not imposed on public charities. Some, but not all, of the objections to foundation-donor corporate control were framed in terms of breach of fiduciary duty.

The 1969 act policed other foundation practices not related to fiduciary duty. Two such provisions regulate a foundation's granting of travel-study funds to individuals and require a foundation to exercise "expenditure responsibility" over its grants to nonpublic charities (§§4945(d)(3),(4)(B)).

Not only does the 1969 law impose a more detailed and stringent set of substantive rules on foundations than on public charities; it sets up a more assiduous sanctioning system. Public charities accused of fiduciary misconduct risk loss of exemption. Although draconian, this result does not derive from a deliberate congressional sanctioning decision but is the natural consequence of an IRS determination that the organization no longer meets the §501(c)(3) test of "operated exclusively for . . . charitable purposes." Moreover, such an "all or nothing sanction" leads to "breakdown of enforcement" (New York State Bar . . . 1965, 713), for the IRS hesitates to request such an outcome, and the courts even more rarely decree it. By contrast, when enacting the 1969 law for foundations, Congress created a special set of sanctions: penalty taxes imposed on both the foundations and the managers or donors involved in the transaction—a set of sanctions that, with a single exception unrelated to the police function, is not imposed on public charities. Ironically, at the same time as it created these penalty taxes, Congress paid at least formal respect to the role of the states. The 1969 act required that the charter (or other controlling instrument) of every foundation be amended to include all the policing restrictions imposed by Congress through the tax system, thus giving state attorneys general and courts an extra enforcement tool: the capacity to complain of a violation of the foundation's own charter. But this bow to the states was accompanied by the imposition, for the first time, of a direct federal penalty unrelated to the tax exemption or deductibility status of the foundation.

Accordingly, the jurisdictional questions that arise generally in connection with the police function take on special force in the foundation area: here, Congress went beyond imposing conditions on exemption (as in the case of the public charities) and created a special regulatory tax. Constitutionally, the taxing power is virtually unchallengeable, but as a matter of legislative appropriateness, eyebrows may well be raised about the use of the taxing power to regulate conduct traditionally consigned to state control and with no conventional federal interest present (such as protection of interstate commerce or enforcement of federal constitutional rights). This subject has received surprisingly scant treatment from the research community.[48] The substantive question—the justification for the foundation policing rules themselves—has received somewhat greater attention: the rules have been defended in U.S. Treasury Department (1965, 1969) and congressional reports (for example, Senate Report no. 91–552) and questioned by some scholars (Bittker 1973). Once again, however, full theoretical and empirical examination remains to be performed.

THE BORDER PATROL FUNCTION OF NONPROFIT TAX LAW

In its efforts to keep nonprofit organizations from wandering off their reservation into the territory of government and business, the tax system reaches far and wide. Here we sketch the scope of this border patrol function, outline the arguments surrounding it, and briefly discuss the research, past and potential, that bears on these arguments.

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[48] I have raised questions about the use of federal power in this area (1965). Specifically on the issue of federal excise taxes, Loeser (1986) is examining the use of this taxing power in the special context of the lobbying restrictions applicable to public charities. And see Troyer (1973) on the constitutionality of excise taxes imposed on foundations that engage in lobbying.

The Government Border

The Restraints

The federal tax code limits the channels through which nonprofits can participate in public affairs activities, here defined as "those activities which seek to study, criticize, inform people about, and modify the actions of the executive, legislative, and judicial branches of government at all levels" (Simon 1973, 61). The prohibitions bind some groups more than others. Although Ring I organizations are minimally restricted (see table 5.1), public charities (Ring II) operate under these constraints:

- They are totally prohibited from engaging in electoral politics (§501(c)(3)), although educational programs may indirectly assist a candidate's cause.
- They are prevented from engaging in legislative activity beyond an "insubstantial" degree, unless they elect to come under an optional rule imposing certain percentage ceilings on direct lobbying and lower ceilings on grassroots legislative action (§4911).[49] These limitations do give way to fairly substantial exceptions; for example, legislative activity does not include disseminating the results of "nonpartisan analysis, study or research" or providing testimony in response to a written request from a legislative committee. Where these exceptions do not apply, the lobbying charity must either (1) navigate within the vague "insubstantiality" rule in order to retain exemption (a restraint, as noted above, upheld by the Supreme Court as a valid condition on a federal "subsidy") or (2), if the charity elects the percentage option, face special penalty taxes if the ceiling is breached.
- They are subject to special rules regulating the financing and control of public interest litigation (Hopkins 1983, 109–11).

Some public charities seek to gain their public affairs ends through public education rather than through direct participation in the governmental arena. These groups may have to meet a rule recently proposed by the IRS making §501(c)(3) status depend on the degree to which the educational program relies on unsupported views, factually distorted presentations, and emotionally based inflammatory statements (Schwarz & Hutton 1984).[50]

If the nonprofit organization is a foundation (Rings III or IV) rather than a public charity, the foregoing restrictions are augmented by the following:

- An absolute prohibition on lobbying, that is, without the ability either to rely on an "insubstantiality" defense or to elect a percentage ceiling option, although most of the exceptions to the public charity lobbying rules apply to foundations as well, and a foundation is not chargeable with lobbying by public charities using the foundation's grant if it was not earmarked for lobbying (§4945(d)(1), Reg. §53.4945-2(a)(5)).
- A rigorous restriction on conduct or support of voter registration activities, including a requirement that the voter program be conducted on a multistate, multifunder basis (§4945(d)(2)).

Moreover, these foundation rules are backed up by the penalty tax sanctions described in the police function discussion above, and by a regular foundation audit program under which the agents appear to devote special effort to the search for evidence of possible violations of the lobbying restrictions.[51]

Looking at both the public charity and the foundation rules, it appears that the only variety of public affairs activity that is unrestricted for all nonprofits is the monitoring of the policies and performance of government agencies (Fleming 1972; Douglas & Wildavsky 1978). This activity, too, would have been barred to foundations under a tentative proposal by the House Committee on Ways and Means (1969, 4) that foundations be precluded from "any activities intended . . . to influence the decision of any government body." The proposal was soon dropped by the committee, although, in a nontax setting, a rule very much like the Ways and Means proposal was temporarily adopted by the Office of Management and Budget in 1981 as a criterion for federal grant and contract eligibility for nonprofit and for-profit entities.

Explaining the Restraints

What explains this network of tax law restraints? Postponing a discussion of the general theory of border patrol, let us briefly review the specific arguments that are made in behalf of fencing charities out of the public affairs arena—arguments categorized as follows in my essay on foundations in public affairs (1973):

- *Definitional* arguments, based largely on assumptions about the etymological and historical meaning of *charity*, or on the administrative difficulty of determining when political activity is charitable.
- *Effectiveness* arguments, contending that charitable involvement in public affairs controversy is either unneces-

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[49] 49. The right to elect these percentage limitations is denied to church groups—at their own request. This somewhat surprising scenario is discussed by Alexander (1978).

[50] 50. An earlier IRS test, requiring the educational organization to present a "full and fair exposition of the pertinent facts," was held to be unconstitutionally vague (*Big Mama Rag, Inc.* v. *United States*, 631 F.2d 1030 [D.C. Cir. 1980]).

[51] 51. This statement is based on the author's own experience and conversations with foundation executives.

sary in terms of social need or dangerously divisive and polarizing.

- *Normative* arguments, contending that public affairs activity offends against "(1) a concept of fair play as between users of pre-tax and after-tax dollars (the 'unfair competition argument') and (2) a concept that it is undemocratic for 'nonaccountable' institutions to use 'public' funds to affect the outcome of governmental decisions (the 'shadow government argument')" (Simon 1973, 73).
- A *prudential* argument, suggesting that, at least as a matter of self-regulation, charities eschew public affairs activity because "politicization" of charity might provoke political reprisal and loss of legally favored status.

Full discussion of these arguments requires consideration of history, social science, and tax theory materials that cannot be addressed in this space. It is also true that

> the answer to all the arguments considered under both the "normative" and "effectiveness" headings is, to some degree, empirical. For example, . . . the answer to the "unfair competition" argument admits the possibility of litigation between an exempt organization and a nonexempt individual, but suggests that such a clash is in fact highly unlikely; and the answer to the "shadow government" objection concedes that a foundation might be able to swamp the decision-making processes in a small polity—but contends that this is a fairly remote possibility. (Simon 1973, 91)

In the absence of adequate data on these points, I resolved the public affairs controversy *against* government restrictions by relying on a threshold "presumption in favor of full participation, by all individuals and groups in society, in all of the processes by which our public policies are formulated" (p. 64). But although presumptions are a legitimate aid to near-term resolution of difficult policy matters, they do not obviate the need for research. In this field, a full and difficult agenda waits to be tackled.

The Business Border

Turning from the nonprofit-government border to the nonprofit-business border, we find that the federal tax law has erected two forms of fences that restrict (1) *commercial activity* by nonprofit entities and (2) *business ownership* by foundations.

Restraints on Commercial Activity

The commercial activity issue has come increasingly to the fore in the 1980s as voluntary organizations of all kinds have scrambled to cope with the combined impact of government reductions in the rate of social service and cultural spending (thus thrusting greater burdens on the nonprofits), government reductions in the rate of grant and contract support for the nonprofits themselves, and charitable giving levels that have not increased fast enough to make up the gap (Urban Institute 1983). The nonprofits' course, predictably enough, has been a rush toward earned income—increased reliance on fees for services, entry into new or expanded forms of commercial operations (whether or not related to the nonprofit's charter purposes), and acquisition of revenue-producing assets distinct from traditional passive investment holdings (Crimmins & Keil 1983; chapter 21 in this volume). The approach was foreshadowed in a *New Yorker* cartoon (December 15, 1976) depicting Santa Claus saying to his elves: "I've been thinking. This year, instead of *giving* everything away, why don't we charge a little something?" Some of the more colorful recent examples of "charging a little something" include the operation of a blackjack casino by North Dakota social service agencies and the acquisition of a Nevada brothel by the Moapa tribe of the Paiute Indians (*New York Times*, November 4, 1984, 31).

Earned income activities have been largely responsible, according to Salamon (see chapter 6 in this volume), for the fact that many nonprofits have weathered the recent fiscal climate better than might have been expected. But these activities have also generated fresh interest in tax law border patrol along the charity-commerce front. For one thing, there have been demands for strengthening of the principal border patrol instrument: the tax on unrelated business income of nonprofit organizations (§§511 ff.). This tax, originally enacted by Congress in 1950 in the wake of New York University's indirect acquisition of a macaroni company, is imposed on a "trade or business" that is "regularly carried on" by a nonprofit and not "substantially related" to the nonprofit's exempt purposes. The legislative history of the tax reflects a congressional desire to avoid "unfair competition" between taxable and nontaxable businesses, although alternative explanations of the tax, not based on competitive considerations, have been developed (Schwarz & Hutton 1984, 680).

As the traffic in nonprofit commerce has grown, the IRS has undertaken new and more controversial enforcement measures relating to the tax on unrelated business income, which have led to litigation over group insurance programs, advertising, sales of mailing lists, and many other income-generating activities (Schwarz & Hutton 1984, 681–92). Moreover, small business groups, including a branch of the U.S. Small Business Administration (1984), have sought to cut back on the large number of exceptions Congress has grafted on to the tax over the years (for example, an exception for nonprofits doing basic scientific research, an exception for work performed by volunteers)—and, indeed, to tax even the "related" business income of nonprofit organizations. Earlier efforts to expand the coverage of the tax resulted in a repeal of the special exemption for church groups (it probably would have been declared unconstitutional in any event [Joblove 1984]) and in a shrinkage of the exception for rental income (§514). The more recent efforts to strengthen the tax, however, have not yet achieved success, partly because of the fiscal woes recited by the charitable groups in opposing tougher rules—and partly, perhaps, because the theoretical and empirical justification for the unrelated business income tax is itself controversial.[52]

The theoretical controversy turns on alternative hypotheses about the impact of tax exemption on competitive fairness. There appears to be general agreement that property tax exemption assists a nonprofit in a contest with taxable competitors. With respect to the federal income tax, however, opinion is divided. The assumption underlying passage of the 1950 legislation appears to have been that exemption permitted charities to undercut the prices of their taxable competitors and also allowed expansion with "free" capital—in the form of nontaxed retained earnings—not available to nonexempt rivals. Some economists rebut the first of these propositions on the ground that income taxes are not a "factor of production" that enters into price setting. Similarly, Bittker and Rahdert (1976, 319) have questioned "why the price level that had maximized both the pretax and after-tax profits of the enterprise before [acquisition by a tax-exempt organization] would not continue to maximize its profits thereafter." Hansmann (1981b, 28) contends, however, that the "free" capital proposition makes sense if it is interpreted to mean that "exemption from income taxation does permit nonprofit firms to grow faster than they could if they were taxed, and it does give them an incentive to grow, and ultimately perhaps to take markets away from for-profit firms, in a broader range of conditions than would be the case without exemption."

Another perspective comes from Rose-Ackerman (1982), who argues that the relevant unfairness issue raised by exemption does not involve competition between firms in the same industry but competition between firms in industries with "tax-favored firms" and firms in those industries without "tax-favored firms." The latter problem, she contends, arises when nonprofits turn from "unrelated" (and therefore taxable) commercial activities to "related" commercial activities in industries whose firms had not previously faced competition from nonprofit, "tax-favored" enterprises.

To those who see the nonprofit firm as enjoying competitive tax advantages, the National Assembly has recently responded, on behalf of its nonprofit agency members, that small businesses enjoy a congeries of tax advantages of their own, buttressed with Small Business Administration preferences, that at least offset any benefits that accrue to the nonprofits (Wellford & Gallagher 1985).

Empirical work has not kept pace with the theoretical debate. Hansmann (1982) examined the impact of a variety of state taxes on the relative prevalence of nonprofit and for-profit firms in various jurisdictions, finding, inter alia, that state income taxes made a difference—thus suggesting that federal income tax exemption may give a competitive advantage to nonprofit competitors. Yet we lack field investigations that examine concrete competitive arenas—and the behavior of nonprofit and for-profit firms within them—in a way that would cast light on the various theories mentioned above (see Bittker & Rahdert 1976, 320–21). It does not appear, for example, that there have been detailed case studies of specific settings in which competitive unfairness has been alleged—for example, the research, travel, and stationery industries discussed by Spiro (1979) and the other industries listed by Pires (1985)—in order to examine what tax or nontax factors have played an influential role. Such evidence could help congressional committees weigh the claims made in the course of the current debate over the tax on unrelated business income. This evidence could also throw light on another tax fairness issue not usually mentioned in the literature: the question of whether the ability of a §501(c)(3) organization to receive deductible contributions and foundation grants provides it with a financing capacity that has competitive consequences distinct from the impact of tax exemption.

Controversies over *state* tax exemption for charities also raise the specter of competitive advantage from time to time. Complaints about nonprofits enjoying commercial income while occupying tax-exempt real estate include claims of a competitive foul. And such claims sometimes trigger action by state or local tax officials to revoke property tax exemptions of groups engaging in commercial activity.[53] Even though, as noted, there is more agreement about the effects of property tax exemption than about the effects of income tax exemption, the issue of competitive unfairness resulting from property tax relief has undergone a degree of theoretical and empirical scrutiny even less searching than similar issues arising under federal taxation.

Unfair competition is not the only rationale for patrol, via the tax system, of the charity-commerce border. Other concerns may provoke requests that the border be tightened: a desire to minimize revenue loss through exemption; a fear that if the world of charity, through a process of isomorphism (DiMaggio & Powell 1982), comes to look too much like the world of business, public support for the nonprofit sector—in terms of funds, volunteering, or legislative support—will weaken; the prospect of charitable goals and values being abandoned in the rush for revenue; and, more generally, the possible erosion of a sectoral division of labor in the society—to be returned to below. To each of these worries there is a possible answer, in addition to the more general response that the tax system should not be used to vindicate non-tax-related anxieties; these rebuttals, however, cannot be developed here.

Another border patrol issue involves commercial ventures between nonprofit and for-profit entities to enable both parties to benefit from income tax business deductions and credits captured by the for-profit. One such mechanism is the limited partnership, which the nonprofit organization forms and joins as a general partner in order to attract for-profit investors into, for example, a housing or theatrical venture; the investors can shelter their personal taxable income with partnership write-offs, and their capital is thereby attracted to the charitable enterprise. A second mechanism is the sale and lease-back: here, property owned by a nonprofit—property that could give rise to depreciation allowances, investment tax credits, and other write-offs in the hands of a taxable (for-profit) owner—is sold to such an entity, which leases it back to the nonprofit under terms that allow the two parties to share in the tax savings enjoyed by the taxable owner. The IRS has attacked some of the partnership arrangements on the ground that the nonprofit general partner, in order to honor its fiduciary duty to the other partners, may have to sacrifice the interests of charity, thereby violating the "operated exclusively for . . . charitable purposes" clause (Philanthropy Monthly 1984).[54] And both of these mechanisms have been restricted in recent tax legislation limiting depreciation allowances and the investment tax credit in these settings (§168(j)). Scholarly critiques have challenged these legislative and administrative border patrol measures (Schill 1984; Pang 1985), but here, as in the competitive unfairness case, empirical investigation—scrutinizing, for example, the factual basis for the IRS fiduciary concerns—has not been forthcoming.

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[52] Similar controversy regarding unfair competition issues is encountered in discussions of the possibility that "too much" commercial activity will not only trigger the tax on unrelated business income but result in a total revocation of the organization's exemption. The revocation question has been examined in great detail by Gallagher (1984).

[53] The operation of fitness centers by nonprofit organizations, suc as YMCAS, has prompted some of these tax-exemption controversie Complaints by for-profit racquet clubs are reported to have led revocation proceedings against the YMCA in Multnomah County (Por land), Oregon, which resulted in a county assessor's decision that YMCA property should be restored to the tax rolls and taxes assessed past years as well (*Wall Street Journal*, March 31, 1986, 2d sec., p. 1

Restraints on Business Ownership

The nonprofit-business border patrol measures mentioned so far—taxing unrelated business income and restricting joint ventures—apply to all nonprofits (Rings I through IV). However, here as elsewhere in nonprofit law, foundations are subject to an extra degree of constraint not imposed on the other nonprofits. Organizations in Rings I and II can hold corporate control stock, that is, a sufficient number of shares to give the nonprofit, alone or in conjunction with the donor of the stock, working control of the company. Foundations are effectively barred from these investments. The "excess business holdings" provision of the 1969 Tax Reform Act (§4943), crudely summarized (it may well be the most complicated section in the entire code), requires foundations to divest themselves of business interests that, combined with interests held by donors and other related persons, amount to more than 20 percent of the voting power of a company. Foundations possessing such excess business holdings as of May 1969 were given long periods of time (ten to thirty-five years, depending on control percentages) to achieve divestiture, but after May 1969 foundations were not permitted to acquire such holdings by purchase, and if they received them by gift or bequest, they were required to dispose of them in five years.

At lengthy hearings held before a House subcommittee in 1983 (Subcommittee on Oversight 1983), foundations expressed their concerns about the impact of these provisions, and the Treasury pointed to the evils §4943 was supposed to correct. The outcome, a year later, was a rather modest hardship relief provision for foundations subject to the five-year divestiture schedule (§4943(c)(7)). Perhaps the reason for the somewhat inconclusive outcome was the fact that so little data were available—in 1983 or when the original law was passed in 1969—to throw light on the claims and counterclaims about §4943.

Thus, the Senate Finance Committee report on the 1969 Tax Reform Act (Committee on Finance 1969) set forth three concerns about foundation participation in corporate control:

> [1]Those who wish to use a foundation's stockholdings to retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. . . . [2] Even when the foundation attains a degree of independence from its major donor, there is a temptation for the foundation's managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. . . . [3] Where the charitable purposes predominate, the business may be run in a way which unfairly competes with other businesses. (pp. 449–50; numbers added)[55]

Only in support of the first claim (low productivity) was any aggregate data submitted by the Treasury in 1969—information rebutted by my calculations (Simon 1965; revised data appear in Troyer 1966, 987–88)—and no subsequent effort was made to update this information. No evidence at all was offered in support of the second claim (diversion) (see Bittker 1973, 151–52). And only a single illustration was offered, in a U.S. Treasury Department report (1965), in support of the third claim (unfair competition).

On the other hand, there was a comparable absence of solid empirical grounding for the concerns, expressed in 1969 and 1983, about the negative impact of the excess business holdings rule. These asserted fears fell into the following categories, which I outlined in a statement for the 1983 House hearings (Subcommittee on Oversight 1983, 1626–47):

1. The provision may force stock divestiture at fire-sale prices, thus causing unintended windfalls for buyers or diverting investment resources from urgent capital needs.

2. The provision may cause sales of corporate control stock to chains or conglomerates, thus reducing the diversity of corporate ownership, frustrating the congressional policy

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[54] The Treasury does approve these arrangements where the partnership instrument permits the charity to act solely in the service of its exempt purposes (Schwarz & Hutton 1984, 693).

[55] Another possible complaint about foundation corporate control—that it can facilitate dynastic control of business corporations, free of the impact of the estate tax—was not advanced by the House committee. It is discussed in Simon (1965, 1978). This is not an aspect of the corporate control problem that is amenable to empirical evaluation; the issues are largely normative.

that favors continuity of-family businesses, or withdrawing jobs from local communities.

3. The provision may discourage the flow of funds into the foundation field, thus restricting the foundation birthrate (with adverse consequences for the strength and diversity of foundation funding) or reducing total resources going to the nonprofit sector at a time of need.

4. The provision limits the allocational freedom of persons whose wealth is tied up in an ongoing business, as compared to those with more liquid forms of property.

Although the fourth point is not susceptible to empirical proof, the others are, but they have been the object of very little investigation. A few foundations have testified about the difficulty of getting a fair price for their excess business holdings or about the scarcity of nonchain buyers, but the general situation does not appear to have been surveyed.[56]

A Larger View of Border Patrol

Analyzing the tax law's efforts to police both the nonprofit-government and the nonprofit-business borders reveals a slim body of theoretical work and an even thinner empirical base. Many of the research questions that deserve scholarly attention have been specified in these pages, with at least the implicit suggestion that this agenda be taken seriously. Candor, however, compels the speculation that border patrol may be one of those areas observed by Lindblom and Cohen (1979) where beliefs are too strongly held to be modified by research findings. It may seem farfetched to assume that Congress, or the American people, care very deeply about what we have called border patrol: it sounds like a fairly recondite topic to engage strong passions.

Power and *order*, however, are themes that generate heat, and both are implicated in the border patrol function. The notion of relatively nonaccountable groups wielding power over the country's governmental and business institutions may explain some of the tax measures we have canvassed. This surmise may be especially plausible when explaining the extraordinary rigor of border patrol constraints imposed on foundations, for, as noted earlier, they are the least "accountable" inhabitants of the nonprofit world (Simon 1978, 9). "Ironically, however, it is quite possible that 'foundation power' is less, rather than more, impressive outside the nonprofit bailiwick than it is within that sector," because of various political and legal control mechanisms that make it difficult for foundations—and for that matter other nonprofits—to wield power in the marketplace or polity (Simon 1978, 9–10).

An even broader ground for border patrol measures lies in the concept of order in institutional arrangements. That notion probably buttresses our adherence to the concept of separation of powers (executive, legislative, judicial), our efforts to keep federal-state jurisdictional lines straight, and our fascination with organization charts. The nonprofit entities that stray from their territory are thus guilty of disorderly conduct, of minding someone else's business. This speculation may not survive sustained scrutiny. But if it does, then another irony presents itself: that in our quest for order via border patrol, we may have ignored another fundamental American credo—that of checks and balances. Although nonprofits may not be able to exert conclusive power over other institutions, they can at least question and challenge and suggest alternate approaches. Here, perhaps, we find the quintessential contribution that our third sector makes to the health of the social order. Do border patrol tax measures limit that check-and-balance role? In the scholarly tradition, we leave this section with that question.

CONCLUSION

The place that the tax system—particularly the federal tax system—occupies in the nonprofit sector has become ever more central in recent decades: the support and regulatory functions covered above have become an increasingly important factor shaping the behavior of America's third sector. To some extent, taxation's presence was bound to grow, given the historically indissoluble relationship between taxes and charity noted at the start of this chapter and given also the ineluctable tendency of governmental support to beget governmental regulation.

What is striking, however, is the degree to which the tax system's forays into the nonprofit realm have been unaccompanied by a coherent theory of intervention or by empirical support for intervention. Thus, as we have noted, the support function itself—when viewed as a system to induce giving—is not based on any well-developed motivational theory of giving or a comprehensive body of evidence on the subject. The equity function is not grounded on an adequate rationale for or against a redistributional role for charity, or any empirical data about its redistributional impact. The justification for part of the police function of the tax system is hard to discern, as are both the theoretical and the empirical underpinnings for much of the border patrol function.

So far, the consequences of this somewhat carefree growth in tax jurisdiction do not appear to have been baleful. True, there has been some impact on the overall configuration of the nonprofit sector. Thus, the foundation regulations, restricting corporate control and other behavior, may well have slowed the birthrate within the foundation field and therefore limited the diversity of the nonprofit sector's ecology. Despite the breadth and depth of the tax system's shadow, however, it has not yet appeared to affect the autonomy and health of the vast majority of nonprofit organizations. In part that happy result flows from the rather remarkable self-denying ordinance under which Congress and the IRS have lived: refusing, for the most part, to seek programmatic control, that is, declining to intervene into the substantive decisions of nonprofit institutions and their donors. But further proliferation of tax regulation could have consequences for the program decisions—and therefore the independence—of the independent sector.

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[56] The third point listed above—involving the flow of funds to foundations and the birthrate consequences—is the subject of a joint study being conducted by the Yale Program on Non-Profit Organizations and the Council on Foundations, referred to in n30.

This may, therefore, be the moment for a moratorium on further tax regulation of the nonprofit sector—a time to catch our collective breaths, a time to think through and test the justification for where we are and where, in the years to come, we seem to be heading.

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Chairman PICKLE. Well, we thank you.

Now we go to James Bennett, professor of political economy at George Mason University.

Mr. Bennett.

STATEMENT OF JAMES T. BENNETT, WILLIAM P. SNAVELY PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, GEORGE MASON UNIVERSITY

Mr. BENNETT. Thank you, Mr. Chairman.

I'm delighted that we're having hearings on this topic. I have been working on it for almost a year and have produced a book manuscript. For an academic, it's a little frightening to think you've worked on a book that there may be considerable interest in. And from looking at the number in this room, it seems like the issue is one of great interest.

I'll be very brief. I'd like to say first that I'm not against tax-exempt organizations by any stretch of the imagination. I happen to work for one. Nor am I against competition. I think that any group, organization, or individual that would like to enter a commercial activity should be encouraged to do so. But I think that it's fairly clear from the research that I have done over the past year that, when nonprofits engage in commercial activities, these organizations do so with special advantages that are conferred by Government. The unrelated business income tax was passed back in 1950 specifically to eliminate unfair competition in a case regarding the Mueller Macaroni Co. in the pasta market.

I think it's clear that the unrelated business income tax really hasn't worked or these hearings wouldn't be held today. And one of the reasons is that it's only a very small part, I think, of a total problem or total package of subsidies and regulatory exemptions that permit nonprofits to have a significant advantage in the marketplace. Such things as postal subsidies are also important.

Let me also add that if you look carefully at the special privileges given to nonprofits, some of them have had extremely negative social consequences. I call to your attention the Nonprofit Institutions Act of 1938 which, without going into detail, permits nonprofit hospitals to buy drugs at substantially lower rates than other organizations. And congressional hearings have shown that the entire prescription and pharmaceutical drug distribution chain in the United States is threatened because of the diversion market that has developed as a result.

It's not just that nonprofits are given an advantage, but it's also the fact that for-profits have to pay higher taxes for these subsidies and higher postal rates. The cost structures of nonprofits are lower, but the cost structures of for-profit organizations are raised by these special privileges.

I would like to also point out that the public sector is a major competitor with the private sector, and it obtains many of the special exemptions granted to nonprofits. And the GAO has shown, for example, that hundreds of thousands of Federal employees perform more than 10,000 commercial activities, and the same is true at the local level of government.

And it seems to me, in conclusion, Mr. Chairman, that the cure is relatively simple; that when nonprofits engage in commercial activities, they should do so through for-profit subsidiaries and operate under the same ground rules that govern commercial taxpaying businesses. It seems to me that the Constitution guarantees equal treatment under the law, and that's what we should expect in this case as well.

Thank you.

[The statement of Mr. Bennett follows:]

TESTIMONY OF JAMES T. BENNETT,
WILLIAM B. SNAVELY PROFESSOR OF
POLITICAL ECONOMY AND PUBLIC POLICY
GEORGE MASON UNIVERSITY

Mr. Chairman, members of the committee, I am James T. Bennett, an Eminent Scholar at George Mason University in Fairfax, Virginia, who holds the William P. Snavely Professorship of Public Policy and Political Economy. My research interests focus on the economic relationships between the public and private sectors and my most recent project is a forthcoming book entitled Unfair Competition: The Profits of Nonprofits.

I am pleased to address this hearing on the Unrelated Business Income Tax (UBIT), because it raises the issue of commercial activity by nonprofit organizations which enjoy special privileges not given to for-profit firms. The unique privileges accorded nonprofits, especially exemption from taxation, lowers their costs of production significantly relative to their for-profit counterparts. Because for-profits operate in a different and far more restrictive and difficult economic environment than nonprofits, competition between the two sectors is inherently unfair, tilted heavily in favor of the nonprofit entity. The commercialization of nonprofits has serious economic consequences for the future of the U.S. economy, for it reduces the rate of economic growth and inhibits the creation of new jobs: Nonprofits have systematically used their privileged position in society to compete unfairly with small private firms by predatory pricing, thereby driving existing taxpaying businesses from the market and discouraging the formation of new ones. The UBIT, enacted in 1950 to prevent unfair competition, has been totally ineffective: The law is costly and difficult to enforce; enforcement is and has been erratic; and, the law is riddled with exceptions and provides numerous loopholes.

At the outset, it is essential to stress that exemption from federal income taxes is but one of a host of special privileges that permit nonprofits to compete unfairly. Nonprofits also enjoy special treatment by state and local governments with regard to taxes, regulations, posting of bonds, and inspections; and federal law provides favorable treatment of nonprofits in areas such as unemployment insurance, fair labor standards, antitrust and securities regulation, bankruptcy, preferential consideration in the award of many contracts and grants, and exemption from the jurisdiction of the Federal Trade Commission. This list is by no means exhaustive. Federal law even treats employees of nonprofits differently and nonprofit postal rates are a fraction of those charged to for-profit firms. Even if the UBIT were rigidly enforced and strengthened, nonprofits would still enjoy massive cost advantages which would permit them to compete unfairly. In addition to their legal exemptions from taxation and regulations, nonprofits benefit from their "image" as charitable institutions devoted to helping the unfortunate in society, even though fewer than 10 percent are actually involved in assisting the nation's needy.

My research on unfair competition by nonprofits is extensive and, due to limitations of time and space, only a brief overview of the issues can be given here. Unfair competition is a serious and growing problem that has reached epidemic proportions in recent years. The nonprofit sector is now huge, consisting of about 1.2 million organizations (including roughly 400,000 religious groups) which produced about 10 percent of the nation's output in 1986. Nonprofits employ approximately 11 million people (including volunteers)--five times more than the automobile industry. The number of nonprofits is expanding rapidly: Fully 2 of every 3 nonprofits currently operating were formed since 1960. The reason that unfair competition has recently surfaced as a major issue and calls for a review of the UBIT have intensified is that commercial activity by nonprofits is growing at a very rapid rate--nearly 70 percent of the nonprofits have started some form of commercial activity in the last 12 years.

This shift to entrepreneurial ventures is fueled by a desire to offset reduced funding by government and to diversify sources of revenue. As more nonprofits successfully compete in the marketplace, others are encouraged to do so and the phenomenon loses it social stigma. Success in one commercial venture encourages the trustees and administrators of nonprofits to attempt others. There is no question that nonprofits can be highly successful in the world of commerce with their lower costs resulting from tax exemptions, the use of volunteer workers, subsidized postal rates, and various regulatory exemptions. The for-profit firm is saddled with higher taxes and postal rates to subsidize the nonprofits with which they must compete. Indeed, an entire industry has already formed with the expressed intent of instructing nonprofit managers on how to go into commercial ventures. If anything, given current budget realities at all levels of government and declining levels of private-support nonprofits, the commercialization of "charity" will accelerate.

The book on unfair competition referred to earlier explores in detail the extent and intensity of nonprofit commercial ventures in several industries and analyzes the economic consequences. In every case, the nonprofits used their advantages to undercut the prices of for-profit competitors, driving many from the market and discouraging for-profit firms from entering the industry. Examples of unfair competition are legion and range throughout the spectrum of goods and services offered by for-profit private firms. Museums sell tours and travel packages as well as goods and services through their gift shops--the Smithsonian, for example, offers tours to 18 foreign countries along with numerous domestic ones; its 13 gift shops and catalog sales operations (mailed at nonprofit rates) generated more than $27 million in revenues last year. Hospitals run health clubs, helicopter services, testing laboratories interior decorating firms, taxicab services, pharmacies, sell hearing aids, and operate catering services, cleaning firms, and laundries. Colleges and universities develop and sell computer software and audiovisual materials, conduct tours for their alumni, offer the use of their physical education facilities and even their dormitories to the public, and offer a staggering array of products for sale at their bookstores. YMCAs compete with private health clubs.

Unfair competition also extends to the public sector when government engages in commercial activities. Governmental enterprises at all levels enjoy the privileges of nonprofits and receive tax subsidies as well. More than 400,000 federal employees are actively engaged in more than 11,000 commercial activities, according to the General Accounting Office. State and local governments also conduct a wide variety of commercial activities, often on a large scale.

The rationales offered to justify the special privileges of nonprofits do not apply to their commercial activities, but only to their "charitable" activities. For-profit firms would not engage in the noncommercial activities that nonprofits perform because of "thin markets" or "public goods" or because of "market failure." Stated succintly, there is a great deal of profit in nonprofit enterprises, as Mary A. Mendelson has shown in her book dealing with the nursing home industry, Tender Loving Greed. Although nonprofit status does not permit profits to be directly distributed to those in control of the nonprofit enterprise, there are many ways (some of which are dubious both legally and ethically) for individuals to profit from nonprofit status. In certain cases, courts have removed the tax exemption of certain YMCAs and at least one hospital because there was no clear distinction between the nonprofit and its for-profit counterpart. The message is clear: Many nonprofits have strayed widely from their purportedly charitable purposes.

Unfair competition is taking a severe toll on taxpaying firms in the private sector. No one knows how many firms have been driven out of business by unfair competition or how many firms were not even formed because of the commercial activities of nonprofits. The economic consequences are obvious: Output is lower, employment is lower, economic growth is retarded and the costs of operating private, for-profit firms is higher and less competitive because they must help bear the cost of the subsidies given to public enterprises and commercial nonprofits. The situation is now serious, but will continue to worsen unless unfair competition is eliminated and all competitors are treated equally in the market. A review of the Unrelated Business Income Tax is urgently needed and long overdue, for this law has not fulfilled its stated purpose of reducing unfair competition. This review, however, should be regarded as a first step in understanding the role of nonprofit enterprise in contemporary American society and ending the pernicious practice of unfair competition. For all engaged in commercial activity to receive equal treatment under the law, as both equity and common sense require, other types of preferential treatment now given nonprofits must also be considered.

Chairman **Pickle**. Thank you, Mr. Bennett.

Now, Mr. Webster, we will be pleased to hear from you.

STATEMENT OF GEORGE D. WEBSTER, ESQ., SENIOR PARTNER, WEBSTER, CHAMBERLAIN, BEAN & McKEVITT

Mr. **Webster**. Mr. Chairman, Mr. Schulze, I appreciate the opportunity to appear before this subcommittee.

My firm represents many nonprofit organizations, including trade and professional associations, foundations, fraternal organizations, and veterans organizations.

I might point out also that many of these organizations are on both sides of the issues that are being studied here by this committee.

I would like to briefly summarize my statement. The first point I would like to make is that the Exempt Organizations Branch of the Internal Revenue Service has done a very good job through the years in handling this very difficult area. There has been some concern through the years, some former IRS Commissioners have suggested that the exempt organization function be transferred out to HHS or some other place, and it's my opinion that the branch itself does a very good job at the IRS. There's a lot of expertise, and it would be a shame to lose all of that expertise that's existing at the IRS.

The general argument in favor of moving has been that the Exempt Organizations Branch is in a tax collecting agency, and they don't collect many taxes. The answer to that I think is that all of their activity comes under section 501 of the Internal Revenue Code and other provisions of the code, and they should stay where they are. They've done a very excellent job in a very difficult area.

The second point that I make in my statement is that, as everybody else has said, the related standard is a very elusive standard. There have been several hundred cases and rulings, and we still don't know precisely what the term "related" means.

However, through the years, a lot of us who practice in this area have tried to come up with another subjective standard, and have been unable to come up with another word or phrase or whatever that we think would be appropriate or would do any better than the related standard. So it's my suggestion based on our experience in my firm, that since we can't come up with a better subjective standard, that should this Commission, in its wisdom, and the Congress, elected officials, decide to tax any new activities or any particular activities, that they do so in a very precise way. Leave the related standard in there, but if you are going to tax some activity, say so, so we won't have to fight about it with the IRS for the next 25 years.

I might say that the Congress has done that with advertising, and that's specifically taxable income of nonprofit organizations. That issue has been taken care of.

The reason we would like to have, if the committee and the Congress decide in its wisdom as elected officials, to tax something, they ought to be specific, is because the majority of nonprofits that you see, particularly in the trade association area, are not large as

AARP or National Geographic, they're small State associations. And if the IRS comes along and makes a proposal to tax some particular activity as an unrelated activity, then they have to fight with the IRS. Many of those cases have not been appropriate on the part of the IRS, and yet the association, just because they hadn't paid the tax, must decide whether it's cheaper to pay the tax than pay an accountant or a lawyer. So that's the advice you have to give them. Why fight with the IRS when it's cheaper just to pay it rather than to pay us or pay some accountant.

So we believe in simplification. If you really want to say something and tax it, well, then tax it, and leave the related standard in there to catch anything else you might want to catch. But, on the other hand, if you're going to tax whatever you're going to tax, say so in very explicit terms and not do it on a subjective basis. I think that can be done in the Internal Revenue Code. It won't add much in the way of page, and it certainly would solve a lot of cost problems from these standpoint of the nonprofit world.

And also I would think that the Internal Revenue Service would be in favor of that because it would make the administration much easier if you know specifically what's taxable and what isn't taxable.

One comment—you had asked for comments on the Treasury proposals. There is a proposal, as I read it, to tax the investment income of 501(c)(6) organizations, trade associations. One factor to be considered is that that might be sort of a Las Vegas push. I'm not sure how much you would pick up if you tax the investment income. That means that the investment income remaining would be reduced, of course, because you would have to pay the taxes, and that would mean that the association then would have to pick up the amount of money needed to operate in additional dues which would be deducted.

So, on the one side, you have the deduction and lose the taxes there. On the other side, you pick up the tax. I think that's a matter the Treasury would have to work out and show you what the figures are.

Thank you.

[The statement of Mr. Webster follows:]

TESTIMONY
before the
SUBCOMMITTEE ON OVERSIGHT
# of the
WAYS AND MEANS COMMITTEE
# of the
HOUSE OF REPRESENTATIVES

by

GEORGE D. WEBSTER
1747 Pennsylvania Ave. N.W.
Washington, D. C. 20006

Mr. Chairman and Members of the Subcommittee:

My name is George D. Webster and I am the Senior Partner of Webster, Chamberlain, Bean & McKevitt. I have practiced law in Washington for over 30 years and my firm represents many nonprofit organizations including trade and professional associations, fraternal organizations and veterans' organizations.

EXEMPT ORGANIZATION FUNCTIONS SHOULD REMAIN AT IRS

I would like to address initially an issue that has been discussed in prior hearings on exempt organizations. Several former IRS officials have suggested that the exempt organizations functions of the Internal Revenue Service be transferred to some agency other than the IRS. Such suggestions have come from within the IRS and from former IRS commissioners. The proposals for change have ranged from suggesting that the regulatory and tax aspects of exempt organizations be transferred to the Department of Health and Human Services to one suggesting that a special agency be set up that would process the present IRS functions in this area. The ostensible rationale for these proposals is that the administration of the tax-exempt organizations by the IRS is not compatible with that agency since it is not strictly a "tax function". Proponents of these separate agencies or transference to another department state that the function of oversight of exempt organizations is regulatory in nature because only a small amount of tax is collected.

It is my opinion that these proposals are erroneous and ill conceived.

There can be no doubt that the regulatory oversight of tax exempt organizations is one best undertaken by the Internal Revenue Service. It is a tax function because the exempt organization area is specifically included within the Internal Revenue Code and this Code is the derivation of all tax matters. Without Section 501 under which most exemptions under the Internal Revenue Code fall, there would not be any tax exemption from federal income tax.

I have had considerable experience in dealing with the Exempt Organizations Branch of the IRS over the years and can state that this organization has performed admirably in its administration of the laws and regulations relevant to nonprofit organizations. There are over one million exempt organizations in existence and, through many changes in the tax laws and inconsistent judicial opinions, it is a difficult area to administer to say the least.

The real need at the IRS Exempt Organizations Branch is not an additional agency but some congressional support to give the staff more examining agents and more support generally.

Of course, the tremendous amount of expertise and experience developed within the Exempt Organizations Division of the IRS cannot be ignored. A removal of the functions of this division to another department would have a disastrous effect on this expertise. New personnel would have to be trained and the administrative expense and bureaucracy involved in this would be enormous. Of course the main parties to suffer under this would be the exempt organizations themselves--organizations which need all the help they can get considering the current state of the Code and enforcement by the courts.

In 1973 a former Commissioner of the Internal Revenue Service offered his opinion as to why a separate agency should be established. He testified before the Subcommittee on Foundations, Senate Finance Committee concerning this and I would like to quote from his testimony:

> "We would recommend a National Commission on Philanthropy. It would be independent of any existing organization. It would be modeled on something like the SEC perhaps, and I should say if there are problems with the completely independent commission, the second step back from the ideal would be a separate organization within the Treasury Department but not within the Internal Revenue Service."

I do not think that this Committee will have any problem in seeing that this kind of approach to exempt organizations is unwarranted and would create more difficulties and costs. Aside from the astronomical expense involved in establishing this separate agency, this kind of thinking flies in the face of the much needed "simplification" that we heard so much about in the Tax Reform Act of 1986.

In short, if it ain't broke, don't fix it.

INCONSISTENT COURT DECISIONS

My second point of testimony today covers the problem created by the inconsistent and inexplicable court decisions in the area of unrelated business income tax.

I am sure this Subcommittee is familiar with the first case decided under the unrelated provision - a horse racing case involving the racetrack at Timonium, Maryland where a Section 501(c)(5) organization was not taxed on the income from horse racing--the horse racing was deemed to be related to the (c)(5)'s exempt purpose. In this first case, the jury took only thirteen minutes to decide that the horse racing activity was indeed exempt from taxation, hardly enough time to flip a coin. Maryland State Fair and Agricultural Society v. Chamberlain, 55-1 USTC ¶9399 (D.M. 1955). Although this was a jury case, the IRS has held to the contrary in Revenue Ruling 68-505, 1968-2 C.B. 248, and continues to adhere to this position.

Another case, Mobile Arts and Sports Association, Inc. v. United States, 148 Fd. Supp. 311 (Ala. 1957), (S.D. Ala. 1957), held that the operation of the Senior Bowl College All Star football game was related to a sports organization's educational and civic purposes. The Court determined that the half-time shows put on by the famed Rangerettes of Kilgore College and Dixie Darlings of Mississippi Southern College provided entertainment with the flavoring of art, dancing and music, and had some educational value. Decisions like these have undoubtedly contributed to the ambiguous nature of the unrelated business income tax.

Also, there have been some confusing rulings by the IRS itself. For instance, the gambling activities conducted by war veterans organizations exempt under Section 501(c)(19) and fraternal organizations exempt under Section 501(c)(8 and (10) were held not to constitute unrelated activity. However, the gambling activities conducted by veterans organizations exempt under another Section 501(c)(4) have been held unrelated. The lengthy explanations in these Revenue Rulings as to this distinction are at best convoluted.

Many of the unusual nuances and carveouts in the unrelated business income tax have been added to Section 511-513. The latest act, the Tax Reform Act of 1986, is no exception to this. For example, there is a provision in that Act that allows bingo games in North Dakota to be exempt from the unrelated business income tax--this is aside from the exemption that currently exists for bingo games by churches.

RELATED TEST IS AT BEST ELUSIVE

One of the problems for the courts, and the IRS as well, is the elusive meaning of the word "related". In 1942, the Treasury proposed language requiring that an activity not to be taxed had to be "necesarily incident" to the exempt function. In 1950, the then Tax Legislative Counsel of the Treasury Department was asked before the Senate Finance Committee what the term "related" meant. His answer was that it was something less than "necessary" and something more than "relevant". This elusive standard adopted in 1950 has caused concern for the courts and the IRS. The Committee should give some study to an alternative definition, if that is possible. The operative phrase "substantially related" can be as elusive as the reasonable man standard of the common law or the prudent man rule in ERISA.

It is fully understood the needs of the federal FISC. With nonprofits receiving $50 million annually in federal deductible contributions, generating approximately $110 billion in fees, sale and investment revenue exempt from federal taxation and holding approximately $300 billion in real estate exempt from state and local property tax, this Committee should look at the unrelated business concept carefully. Nevertheless, I believe the concept, even though elusive, is conceptually appropriate.

I thank you for the opportunity to testify.

Chairman **Pickle**. Well, we thank you, Mr. Webster.

It looks like the panel has stayed within your time. We are off to a good start here this morning.

Let me ask all of you as a group what I was going to ask you individually.

The Treasury has made recommendations in about seven different areas. Some of you have commented on the recommendations but most of you just kind of referred to it in generalities.

Can each of you give me your general reaction? I know that Ms. Clark said she applauded the Treasury recommendations if I remember your statement. Do you have any comments about any one of the items that we ought to be considering, or do you have other suggestions that we might follow on these recommendations?

What do you think about the Treasury's recommendations?

Ms. **Clark**. Mr. Chairman, let me first clarify my reaction. I was applauding the Treasury's recommendation that further information was necessary before any kind of legislative package could be put together, and applauding their identification of the issues which they have highlighted as simply issues deserving further attention.

Chairman **Pickle**. Well, I have the Treasury's recommendations about seven different areas. You're applauding only the part about the need for more data?

Ms. **Clark**. Yes. I'm applauding their thoughtful analysis of the area and their recognition that more information was needed.

Chairman **Pickle**. Mr. Lerner or Mr. Jones or Mr. Webster, what do the rest of you feel about the Treasury? Are you familiar with the recommendations suggested? I assume you are.

Mr. **Webster**. Yes, sir.

Chairman **Pickle**. What we're trying to find out, if we've got a problem here, is what do we do about it?

You may wish to just comment on the Treasury recommendations, but I'm trying to get suggestions or recommendations as to how we approach this UBIT issue.

Do you have any recommendations?

Mr. **Jones**. Speaking for the Section of Taxation, we are often criticized for taking positions without backup of our members.

We have not had a chance to consult with those of our members who are most knowledgeable about the Treasury people. I guess it's a common attribute of lawyers to see if they could get some more time so that we could give this committee an informed judgment. And we would be glad to submit some comments that represent a broader view than that.

Chairman **Pickle**. I'm not asking you what is the position of your Bar Association.

What do you think that you, as one who is in charge of this particular section, what do you think about it in general, you individually?

Mr. **Jones**. I thought they were very thoughtful proposals. Each of them carries implications that I really feel that I wanted to evaluated before I issued a final position on them. I'm sorry.

Chairman **Pickle**. Mr. Lerner.

Mr. **Lerner**. Well, I would share the comment that we would like the opportunity to submit something later on that was in more detail. But there are a few general reactions that I would have, first, on the idea of increasing a threshold, for example, for UBI taxation from a nominal level of a number of years ago to a more realistic level. Sure, that makes sense. I mean those things that bear on the improved administration and would increase the efficiency of the system, I think I would share their views on. The idea of retaining an exemption for activities involving donated labor, I think from a policy standpoint is a highly desirable thing. The same thing would be true for a volunteer exception.

But I think, just as the Bar has indicated, these are areas which really require, I think, a more thoughtful consideration. I would like to give that and supply the subcommittee with my views.

Chairman PICKLE. Well, I may go and see if there are any other comments of the other two witnesses here first.

Mr. Webster or Mr. Bennett, you got any comments about it?

Mr. WEBSTER. Mr. Chairman, I did comment on that proposed taxation of the investment income of 501(c)(6).

Chairman PICKLE. Yes, you did mention that.

Mr. WEBSTER. There is another one here that certainly is clarifying the rules for computing the UBIT, especially in determining the allocation of expenses.

Certainly that's something that ought to be looked at. If you can clarify any of the rules for determining what is unrelated business income, you should certainly do it because, as I said, you know, that's the big fight we've had for years with the IRS as to what is the total amount of UBIT.

So anything that can help resolve that issue, I'd be in favor of.

Chairman PICKLE. Mr. Bennett.

Mr. BENNETT. Sir, it seems to me that the Treasury is trying to get a better handle on the commercial activities of some of these organizations and to tax those. And I think in general it's a good idea, because tax exemptions have not, once granted, persisted. Mutual savings banks, for example, are no longer tax-exempt, although they once were. Although today credit unions are still tax-exempt.

And there's certain inconsistencies in the law. I think that the Treasury should look into it.

Chairman PICKLE. Well, my reaction is is that your testimony this morning is largely that you view with concern this problem. And we thank you for that wise observation. [Laughter.]

But we're trying to get a little more meat on this subject than just viewing it.

Let me ask some of you some individual questions.

I guess, Mr. Lerner, you said that in applying the "relatedness" standard to determine if a tax-exempt organization should pay UBIT, that the Internal Revenue Service provides little guidance. And then you go on to say that, in many instances, an exempt organization is taxed and has no public impression to rely upon deciding whether to treat an activity as unrelated.

Now, can you identify more specifically what kind of guidance we could use or could have?

Mr. LERNER. Well, I think numerically for a period of 5 years, there have been only four published revenue rulings dealing with definitional aspects as they relate to unrelated business income.

That seems to me to be a paucity of guidance by the service in what is now understood to be a very contentious area.

So it would seem to me that if you compared that to the level of activity of published rules in other areas of importance in this——

Chairman PICKLE. There are some kind of cases, types of cases, where it's more difficult to determine whether UBIT should apply to certain organizations, such as in the area of educational institutions——

Mr. LERNER. Educational and hospital organizations, for example, given the dynamics of——

Chairman PICKLE. What other areas?

Mr. LERNER. Hospital organizations, and given the dynamics of business these days and changes in marketing, that you're going to have developing areas in which I think there's need for more guidance. So that's why we would encourage that there be a greater effort for early publication.

Chairman PICKLE. Can you give us any specific examples of areas where the Internal Revenue Service has given contradictory opinions on whether UBIT tax should be paid or not?

Mr. LERNER. Well, let's try some things here. I don't know that these will be entirely responsive, but ancillary services of exempt organizations, whether services in the area of a laboratory or pharmacy are related to the exempt purpose of a hospital.

It's clear that if they are sold to patients, they are. Clearly if they are sold to patients, those services or products are consistent with the exempt purpose and, therefore, the relatedness test is satisfied.

Chairman PICKLE. You've indicated there are some inconsistencies. Can you give us some examples in the areas where IRS is giving contradictory opinions, and are they contradictions in the issuance of private letter rulings, general counsel memoranda?

Mr. LERNER. Let me give you an example in the area of management services to affiliates.

There was a published letter ruling in 1978 which holds that management and accounting services provided by a section 501 (c)(6) trade association to its for-profit subsidiary constitutes an unrelated business. But there are contrary rulings holding that services provided by an exempt organization to a brother/sister corporation in a tiered setting would not constitute unrelated trade or business. It's difficult to draw the distinction in those areas.

Chairman PICKLE. I know you and Mr. Jones and Ms. Clark have all said that we need more data.

How are we going to get more data to look into this subject?

Mr. LERNER. One thing is going to come, I think, from 3,000 examinations of returns.

Chairman PICKLE. Yes, that can be helpful. That can be helpful. And I think we need to study those and examine them more carefully.

But this thing hasn't been looked at now for 19 years. We've been collecting data. And I think if we just say yes, we should collect more data, how do we go about collecting more data? You can study the 3,000 returns or increase that sum.

As some of you said, we need more trained personnel, and we should be careful that we move forward. And we appreciate all that.

But that doesn't give me a good handle to take hold of things. Ms. Clark says no, I think it was Mr. Jones, either of you said we really don't need the "competitiveness" test. You do not favor a competitive test, but you state that the "relatedness" test is better.

But, on the other hand, Mr. Webster, you've indicated that the related test is vague. And we just kind of meet ourselves coming and going on this thing. I'm trying to get to something more specific. and I think that's probably what the rest of us feel. It would help if you could give me some more examples.

Mr. Bennett, for example, made reference to the hospitals. And if nonprofits can buy their medicine cheaper, and then cannot only prescribe it to a patient, but if they can resell it, then, of course, that is a questionable practice in my mind. And that practice is going on now, Mr. Bennett?

Mr. BENNETT. The FBI says that contaminated drugs are in every market in the United States, and they're still on the basis of congressional hearings on this subject, sir.

Chairman PICKLE. Well, is it legal to resell prescribed drugs? I'll ask the question of staff, is it legal within the law for hospitals to engage in those kinds of practices, reselling of drugs?

Mr. BENNETT. The Federal Trade Commission would prosecute this, but the Federal Trade Commission's charter does not extend to nonprofits. Yet another special privilege.

Chairman PICKLE. Ms. Clark, you indicated in your testimony that the complaint of for-profits is not substantiated, that the complaints have been just anecdotal and not factual.

Now, in 6 days of hearings, we've had many examples where they don't think they're anecdotal. They said they've been put out of business. Some have given an example about underpricing. Others that they just can't beat competition.

I take it that you're saying that in New York there have been no complaints of any competition, unfair competition? Is that what you're saying?

Ms. CLARK. No, certainly not, Mr. Chairman. I listened with concern to the complaints, and complaints exist in New York as well as they exist throughout the country.

What I am saying is simply echoing what both the Internal Revenue Service and the Treasury Department said to you in the first day of hearings, and that is they don't have systematic information across the broad specter of nonprofit activities to tell you where there are intersections between the income-producing activities of the nonprofits and for-profits, and where the competition, which we all admit exists, is unfair.

So I think what I am saying is not that there aren't isolated cases, and there have been many compelling cases brought before this subcommittee, but I think what you're hearing from your expert advisors is the suggestion that you need a broader based study, information across the nonprofit sector, before you could conclude that any legislative changes are necessary.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to thank the panel. I think that we can use as a given that we are going to change the method of collecting data in this area. We are going to set up a structure which will be perhaps more computer compatible; that the information will be usable, understandable and will give us the information we need. In my opinion, that's the least amount that the committee will do.

The question is where do we go from there? We have heard testimony that there are abuses and that they are growing. Mr. Webster said that they are growing by 70 percent or something, I forget the exact figure, but it's growing. The complaints are growing. So our problem is do we go further than a more sophisticated collection of data at this time, or do we wait until we get that data and then move?

There is compelling evidence that we should go further. If we go further, how do we take those first steps without going too far?

Yesterday, we had—Mr. Jones, I ought to direct this to you. We had testimony from a gentleman who suggested that when private capital becomes available, let's say a health club or clinic, as it goes out into a rural area and serves a tremendous purpose in aiding that area, and then it gradually builds up to the point where private capital comes in and there is competition; that that would be the time for them to sell that business out and move to another area that does not have the service being provided. In that way they would be fulfilling their charitable role.

Now, it seems to me that would be a tremendous problem in selecting the time to, say, cut it off here and go. But is there any merit at all in that type of an approach?

Mr. Jones. There certainly have been charitable organizations which have functioned in that manner, to bring services to a place they would not be. They, in a sense, provide seed money and they're happy to get out and take their proceeds and go somewhere else. And that's highly to be commended.

I share your concern that that line drawing is extremely difficult to do, and then in some fields it makes sense. The health club might be a very good example.

It is certainly something to look at. I think that the Treasury also suggests that maybe at some time there's a second look at an organization further down the line.

I would like to say that you indicate concern as to what else is going to come from these hearings. I think a lot of what has been discussed here really can be met through the relatedness test. Unfortunately, I didn't take notes on all the examples you had about the aggressive exempt organizations. But I thought that an alert enforcement program recognizing this need could do with that in relatedness.

An important part of relatedness is when you start dealing with third parties and money is changing hands. Then you ought to be thinking about unrelated business income, and the service ought to be thinking about it, and maybe they haven't done it as much. It would seem to me, and I don't know the details of the hospital drug operation, but there again you have third parties, money is changing hands, and that ought to be reachable within the relatedness test.

And on that I think we are all learning from these hearings, and there would be a good result even if no legislation came.

As I said in my testimony, I have more problem about some of the problems that come before this committee which go to the exemption itself. Your health club one talks about it. Is there sometime when what was originally an exempt purpose no longer should be exempt because the private sector is going to take it over. And that, I think, is very much tougher.

Mr. SCHULZE. We all dislike lengthy forms required to be filled out by the Government. I guess there are accountants and tax attorneys who would find them beneficial in the long run.

Is there a way or manner in which we could draft or reconstruct the forms so that they would lead one to a logical conclusion? Have you initiated a new fund raising activity that doesn't involve X, Y, and Z? In other words, is there a way that we could create or craft the form so that it would lead the individual filling out that form to the conclusion that here's an area where we're either treading on dangerous territory or that we should go look at paying an UBIT?

Mr. LERNER. As the only one who likes those long forms, we have the same concerns about excessive paperwork. But I think in this area if we can devise one that would draw someone down to a logical conclusion, I think the answer is clearly yes. But what's needed really is objective standards from a legislative standpoint so that the form is implementing well-established objectively oriented policy.

For example, one of the concerns that we face, and maybe an elaboration of an earlier question by the chairman, as to whether an exempt organization can engage in unrelated activities, it can do so provided it's primarily engaged in activities in furtherance of its exempt purpose. And there are private letter rulings that deal with percentages in that area, and we see, for example, where the definition of primary, which almost everyone would assume would mean not more than 50 percent unrelated, we have private letter rulings that would authorize 75 percent of their income coming from an unrelated activity, 66 percent of expenditures coming from unrelated activity.

Now, I guess if we had a more objectively oriented legislative framework, you could devise a form which would calculate whether that was on the basis of one activity or an aggregate of activities. And you would be able to identify what was excessive by the definition then prescribed, that primary meant less than 50 percent outside activities.

Mr. SCHULZE. But your organization, do you have any more concrete ideas along those lines or examples, we would be happy to have them.

Let me also say that we have given thought to percentages. But again we get into hot water. I would rather not. Maybe we could pick a percentage and say certainly beyond that is excessive. But it's going to be very difficult to say if the Girl Scouts bring in more than 12.5 percent of its income from selling cookies, that then has to be an unrelated income category.

So I'm concerned about percentages unless we use it as an extreme case, and say if you're above 60 percent or 50 percent, something like that, then you really don't sound alarms. But I'm concerned about specifically setting up a percentage test.

Well, even without conclusive and comprehensive data, given the expertise of the panel, do you think that the current law as it is represents sound tax policy in this day and age? Or do any of you think we should do nothing?

Mr. LERNER. I don't think we should do nothing.

Ms. CLARK. It is hard to conclude that nothing should be done.

Chairman PICKLE. You don't think we should do nothing?

Mr. LERNER. I think you should do something.

Chairman PICKLE. Accentuate the positive? [Laughter.]

Mr. LERNER. Mr. Chairman, that's not really intended to be flip. But the point is really that we do agree, I do agree, that this is an area in need of legislative change. We just think that the legislative change ought to be premised upon more complete data and well formulated policy. That's all. And that's no apple pie. I appreciate that though.

Chairman PICKLE. Well, I guess a broader question from my standpoint of view is, do you think current law is satisfactory and is the law being carried out properly now by either Treasury or IRS?

Ms. CLARK. I would certainly react that, conceptually speaking, I think the basic concepts behind the current law are sound, as generally speaking, the Treasury report concludes. This report concludes that the rationale supporting the exemption continues to be sound policy and that the relatedness test is theorectically sound.

Chairman PICKLE. Let's assume that we can all agree on that, that they're sound.

Now, what do we do? Do we leave it alone and let current law basically prevail, or do we try to make general improvements?

It seems to me like we have a problem and we ought to admit it. If there are now upwards of a million tax-exempt organizations and if the volume of the tax-exempt income is in excess of $300 billion, you can take it and you can set down on a yellow legal pad with a No. 2 pencil, and you can figure out that that's a lot of money and these things are growing. And that there's a looseness somewhere.

Now, does it serve a good purpose? Is it worth it? And while we can agree that the concepts are good, the question is whether the law sufficient now to enable the Internal Revenue Service and the Treasury to actually carry out the law and police and supervise all the tax-exempt organizations?

Apparently not, because they are growing in such huge leaps and bounds, or it would appear to be. So I think we not only have to revisit it, we have to try to come up with some kind of suggestions. And I just don't know that I have been given any encouragement by you. I don't want to take your time. I have another comment, but I thank you for yielding.

Mr. SCHULZE. Thank you. You're welcome, Mr. Chairman. We're relatively informal this morning anyway.

One other question for the panel in the area of joint ventures.

Joint ventures are increasing. Can you give us any specific thoughts on where we can draw the line or should draw the line or should address joint ventures with the realization that the halo effect is real? There are those who will take advantage of the halo effect.

Is there a line we should draw? Anybody want to tackle that one? No, none.

All right. I thank you. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Jacobs, we're glad to recognize you and glad you're here.

Mr. JACOBS. Mr. Lerner, the classic question in American literature I suppose is why didn't you tell me you were married. And the classic answer is you didn't ask me.

You made some reference to a change in the reporting system we have in our Federal Income Tax system, and we exalt the proposition of self-reporting, which is predicated on the fundamental integrity of individuals. If that predication were false, I presume that automobile insurance and casualty companies would go out of business in fairly short order. So there is some solid human integrity upon which our society and our system of taxation to conduct the affairs of that society are based.

You mentioned that the present reporting system, self-reporting system, gives to the IRS data concerning those who report unrelated income, but there isn't a very good way to audit the returns and the informational returns from those who do not report unrelated income. From that I infer you are suggesting that the reporting of all nonprofit organizations include perhaps an assertion of no unrelated income or a description of borderline matters.

Is that what you were getting at?

Mr. LERNER. Well, yes, Mr. Jacobs, I am married.

On the point on the TCMP audit, what I really had reference to was that the announced purpose was to examine on a line basis the form 990-T, and that I think it will be desirable to also expand that to include those organizations that haven't filed a 990-T, but that did file a 990, to address the underreporting issues in that context.

Mr. JACOBS. Exactly. Just expand it.

Mr. LERNER. Now, I would suggest that that would be of some assistance if the announced arrangement for the examination was limited to the 990-T, I think it would be a shortfall in that program.

Mr. JACOBS. Well, it's really not uncommon these days, is it, for public forms to require assertions of negatives? No member of my family owns such stock or corporation, et cetera. A big example, the financial statements required by members of the Congress. There are requirements of assertions of negatives, and I wonder if that might not be an area for a development in the reporting by? I mean why didn't you tell us? For example, they tell me that certain YMCAs in the country not only provided travel service for their members, which I take it might well be privileged or protected, but branch out and put ads in the newspapers and say anybody in town who wants an arrangement to the Caribbean or some place, get in touch with your local YMCA and bring on down some money with you.

That dichotomy, those two propositions, in my mind, are clearly quite disparate. And I wonder if it wouldn't be a good idea to ask the YMCA in its reporting to say we engage in no sale of these activities to the general public but only to our own members, or the example which has been used here, in the case of the hospital and drugs might also come into play.

Is there any possibility that we might get a little better operation in terms of this controversy if we required all organizations to assert that they don't engage in certain proscribed activities?

Mr. **LERNER**. I see substantial merit to that suggestion and that increased disclosure would be one way to achieve better policing of the area, yes.

Mr. **JACOBS**. We are not talking about nonprofit organizations. We are talking about not-for-profit organizations, right? Remember the old New Yorker cartoon that, "This is a nonprofit corporation. We didn't plan it that way. That's the way it came out". And as long as I can remember, somebody is always asserting that another nonprofit, and a not-for-profit corporation, the U.S. Government should get out of competition with private enterprise.

The post office ought to get out of the way and stop competing with private organizations which would like to deliver mail. I suppose the FBI should get out of competition with private enterprises eyes, if you carry it to its ultimate conclusion.

Now we are asking what are your borderline activities, and we will make a judgment. It seems to me that would be fertile soil for auditing and coming to some resolution of this controversy, I think.

Chairman **PICKLE**. Let me ask the panel this. We have the form 990 and the 990–T. Nobody seems to like it, particularly, or think it is complete enough. Do you have any suggestions on what we should do about the 990 and 990–T? Is it adequate? Should we make revisions to it? Or do you have any particular feelings about that?

Ms. **CLARK**. Mr. Chairman, certainly my bar association committee would be glad to study both forms, with the questions you have raised today in mind, and make written recommendations. The committee has not studied it, so I cannot speak for them.

I suspect, as an individual practitioner, that the forms could be greatly improved, and that additional disclosure required on these forms would bring to light the information that most people are calling for at these hearings.

So I suspect it would be very fruitful and we would be glad to submit recommendations.

Chairman **PICKLE**. Well, I think the matter of disclosure is something that we can look at. I am glad Mr. Jacobs raised the question. I think we do need more information. I will give you an example. In these hearings, we had testimony from the Independent Sector. These are organizations that represent a hundred-plus very big tax-exempt organizations throughout the United States, and they had written us in response specifically to questions we had raised about more detailed data.

And they said to our committee, in effect, that who or whatever organizations pay the UBIT, or which activities are related or unrelated is privileged information. They also said that they were not going to supply that information, and if we want to get that information we had to go to Internal Revenue Service to get it.

Now this is one of the problems we have had. Organizations who are really using tax-exempt status, the big ones in the country, do not want to give you any information, or very little, and say if you want to get into that, go get it from the IRS.

Now that is kind of paying "hard ball" with the Congress, and I want to say to them, and to this panel, and as one member of this panel, that we are going to get more information. That they have an obligation to give us more facts and more data, and more information.

And for them to be able to just stonewall this question is not acceptable. And I say to all the organizations that we are looking for facts, and we are looking for data. I do not think we are being furnished that data by most organizations because they say, as Mr. Jacobs said, "Well, you didn't ask him. You didn't pull it out of me."

I know how this sounds. I may have a tone of some belligerence, but it is a feeling of frustration. In this very sensitive area, we know there is a gray area. We do not want to do any kind of damage towards well-meaning, nonprofit organizations, we know on the surface of things that we do have a problem, and I do not think the Congress is going to sit back and just rub its hands, and bemoan the fact that we have got a problem.

I would hope that you and your organization, would give us any suggestion you have. I am not asking you to be a reformer, but if we do have a problem here, and you feel it more sensitively than anybody else, then we ask for your help and for your suggestions.

So I just say to the panel, we appreciate your testimony and I would hope that you could feel privileged to contact us again about any other data because we need your help to try to shed more light on this issue.

We are going to try to focus a little more publicity on this subject. It is not satisfactory when the Independent Sector comes up and refuses to give us data, and what little data they give is just about like striking a match in Carlsbad Caverns. It does not illuminate very much.

Now that is not satisfactory, and I think we have got to ask for more cooperation.

Well, I thank the panel very much and appreciate your testimony.

[Pause.]

Chairman PICKLE. Our next panel consists of James Hasson, Susan Rose-Ackerman, Henry Hansmann, J. Edward Shillingburg, and Harvey Dale.

James Hasson represents the firm of Sutherland, Asbill & Brennan from Atlanta, GA.

Susan Rose-Ackerman is a professor of law at Columbia University.

Henry Hansmann is professor of law at Yale University.

And Mr. Shillingburg represents Lord, Day & Lord in New York. I assume that has got to be a law firm.

Mr. SHILLINGBURG. It is.

Chairman PICKLE. It is not an evangelical society. It is Lord, Day & Lord. [Laughter.]

And Mr. Harvey Dale, professor of law at New York University School of Law. Mr. Dale.

Now, I am very pleased to have you here. We consider you the panel of experts. You have just heard this other panel spray a little bit of concern out over this audience. You people are actually practitioners or you study UBIT, and I think that you are probably as familiar with this overall problem as anybody in the country.

So, we thank you for accepting our invitation to come, and we would like to hear from each one of you. We are going to ask Mr. Hasson to commence, and go right on down the line. If you can summarize within approximately 5 minutes, your general testimony, we would appreciate it.

But we are not in that big a hurry. We want you to take a little more time, if you need it, and to give us any advice or suggestions you might have. So, Mr. Hasson.

STATEMENT OF JAMES K. HASSON, JR., ESQ., SUTHERLAND, ASBILL & BRENNAN, ATLANTA, GA, AND ADJUNCT PROFESSOR OF LAW, EMORY UNIVERSITY

Mr. **Hasson.** Thank you, Mr. Chairman. It is a pleasure to be here. Mr. Schulze, Mr. Jacobs, I appreciate this opportunity. I was invited by the staff to come and offer recommendations for your consideration.

I am a practicing attorney representing both small businesses and exempt organizations. I am also a professor of law at Emory University where I attempt to teach the law of this field to graduate lawyers.

You have heard a lot of conflicting assertions and recommendations during the past several days of testimony. It appears to me that you have two basic options. You either stay with the existing structure of the law and work to improve it, or you abandon the existing structure altogether and put something new in its place.

To make that basic choice, you do have enough information to draw several factual conclusions. You have enough evidence to show that the existing law is not now being adequately enforced. The IRS can apply the existing law. They proved this last year by winning two cases in the unrelated business income area in the Supreme Court.

But the IRS does not now provide adequate enforcement, and it does not provide adequate information to the public. As one of the earlier panelists stated, during the past five and a half years, the Internal Revenue Service has published only four revenue rulings and revenue procedures in the unrelated business income area.

That is out of a total of 1,455 rulings of that sort. A similar problem has developed in this area with the regulations promulgated by the Treasury Department.

For example, it took the Treasury ten years to write regulations under section 513(e) dealing with hospital services. Despite the inadequacy of the official publications, almost all of the situations that have been complained of during these hearings have been addressed by the Internal Revenue Service during the course of audits and in the course of preparing private rulings.

Under the existing law, hospitals should pay tax on drug sales to the general public. Colleges should pay tax on the sale of appliances or expensive clothes to students or faculty. That is the law now. But the IRS has not worked this area as it has worked the other areas within its responsibility.

As a result, most citizens, and many exempt organization administrators, do not know the decisions that the IRS and the courts have already made.

A third fact that you are painfully aware of is that we do not have many facts about the related and unrelated revenue-generating activities of exempt organizations. This makes it very hard to separate the real abuses from mere misunderstandings.

A fourth fact that I would note is that we do not have an accurate study to show whether there is a real disparity in tax burdens under the current law. Most of my small business clients do not pay corporate income taxes.

That is because they operate as proprietorships, partnerships or "S" corporations. This means that exempt organizations may in fact have a higher tax burden than some of the small businesses who are complaining.

Even though this is an obvious question, neither the Treasury nor the Internal Revenue Service attempted to answer it during their testimony.

A fifth fact is that the Congress intentionally chose a "not substantially related" standard in 1950. Your predecessors rejected the term "necessarily incident" which was the original Treasury proposal in 1942.

They also rejected the term "directly connected" as being more liberal, or less stringent, than "substantially related". They also rejected "unfair competition". In fact from 1950 to 1967, the Internal Revenue Service tried to use both "primary purpose" and "commercial method" tests for determining unrelated business income, and both of those tests failed.

The current test, that an activity contribute importantly to exempt purposes, may be imprecise, but at least it has the benefit of 40 years of attention from the Congress, the administration, and the courts.

With this factual background, where do you go next? In my written submission I outline at least eight specific options, ranging from staying with the law as it is to developing an entirely new law which would provide an advance decision whether an activity would cause substantial competitive harm to a small business.

From among these options I recommend three specific actions at this time. First, have the Internal Revenue Service develop a plan to improve its enforcement and educational efforts in this area.

This will apparently require convincing the Commissioner, who testified before you that nothing more was needed. But I believe that this subcommittee can persuade the Commissioner that more is needed.

If he does respond, you will then need to support him in the budgetary process. This is not a recommendation to leave everything as it is. The Congress can set the priorities for enforcement of the laws, and this area can receive more attention if the committee so directs.

Second, direct the Treasury and the Internal Revenue Service to do more, and to do it faster. For example, all organizations, including churches, could be required to report all noncontributed revenues of more than a specific number, say, $25,000, and to check a box on the form saying why they think they do not have to pay tax on that particular type of income.

This would give you more of the data you need. This may in fact, require statutory changes. In addition, you have the opportunity to direct the Treasury and the Internal Revenue Service to meet with churches and State colleges and universities, which now do not file a form 990 return, to identify the least burdensome reporting requirements for those organizations.

As a part of this, you should have the administration compare for you the Federal income tax burdens of taxable unrelated businesses of exempt organizations and those of proprietorships, partnerships, "S" corporations and "C" corporations which are in the same business.

You should also have the Treasury tell you why for-profit hospitals and research firms have been able to compete so successfully with nonprofit firms in those areas.

A third specific action would be to direct the Treasury to reconsider and report to you and the public the best methods to deal with the specific problems which have been identified during these hearings.

I suggested several specific problems in my written presentation, as did the Treasury. For example, you could write into the convenience exception specific limitations for food, dormitories, books, supplies, gifts for patients, and equipment which is not readily available from businesses within a half mile radius.

You could also codify the existing IRS position that a payment for quality assurance or other services is not a royalty.

I, as many of the others here, I am sure, will be glad to work with your staff to refine these suggestions. You could then make the decision whether these specific legislation proposals make any sense.

After preparing these remarks, I have had an opportunity to look at the Treasury recommendations. With the committee's indulgence, I have a few comments about specific Treasury proposals.

Mr. JACOBS [presiding]. The committee will indulge that, sir, after the other panelists.

Mr. HASSON. Yes, sir.

Mr. JACOBS. I will say for the edification of the experts, we are proceeding under the 5-minute rule. In the manner of automobile traffic, this green light means the 5 minutes are running; the red light means that they are not. And we would ask that you observe the 5-minute rule, and then, in the questioning period, we will develop comments, we would hope, on the Treasury recommendations.

[The statement of Mr. Hasson follows:]

Statement By

JAMES K. HASSON, JR.

HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 30, 1987

Mr. Chairman and Distinguished Members of the Subcommittee:

I am James K. Hasson, Jr., a practicing attorney and Adjunct Professor of Law at Emory University, in Atlanta, Georgia, where I teach the law of exempt organizations and the unrelated business income tax to graduate lawyers seeking advanced degrees in taxation. In my practice, I routinely advise various types of exempt organizations and numerous small and large businesses about the federal tax laws, so I have had the opportunity to observe both sides of the current controversy over "unfair competition." I also have the privilege of serving the Internal Revenue Service as a member of the Commissioner's recently appointed Exempt Organization Advisory Group.

Your Staff requested that I appear before you today to offer an overview and some suggestions for further action. I have reviewed the prepared statements of many of the witnesses and have reviewed the reports and briefing documents prepared by the Small Business Administration and General Accounting Office.

From all of these materials, it appears that your response can follow one of **two principal themes -- either confirm the basic soundness of the existing unrelated business income tax laws and seek to improve their operation, or abandon the current statutory approach and substitute a new standard and regulatory scheme for the revenue-generating activities of exempt organizations.** Within these two principal themes, there are numerous alternative courses of action. Some of these can be described as follows:

1. Preserve the status quo.

2. Preserve the status quo, but encourage greater voluntary compliance by exempt organizations and improve the level of enforcement by the Internal Revenue Service.

3. Preserve the status quo, but direct the Treasury Department to institute data collection procedures and analyses which will enable the Congress to assess the true nature and extent of revenue-generating activities by exempt organizations and the extent of any disparity in federal income taxation between the unrelated businesses of exempt organizations and independent businesses.

4. Preserve the existing legal structure, but refine it to eliminate uncertainties, curb possible excesses, and promote voluntary compliance.

5. Preserve the existing legal structure, but add "competitive effect" as a statutory criterion for taxation.

6. Replace the existing legal structure with a tax imposed on unreasonable accumulations.

7. Restructure the existing law to impose different standards for the taxation of different types of exempt organizations.

8. Restructure the unrelated business income tax to either tax or prohibit activities by exempt organizations which cause "substantial competitive harm" to a for-profit business.

From the testimony you have heard, there is much to commend the preservation of the existing legal structure. The managers and administrators of exempt organizations, their tax advisors, and the Internal Revenue Service personnel are all generally familiar with the basic concepts of the unrelated business income tax law, most of which has been in place for almost four decades. Those individuals who work most closely with the existing law acknowledge its basic logic and testify to the ability of the Internal Revenue Service, **given adequate resources**, to apply and enforce the existing law.

I do not believe that the facts will support a conclusion that the Internal Revenue Service is incapable of administering the current law. For example,

- The Internal Revenue Service has already drawn the line between related and unrelated college alumni travel services.[1]

- The Treasury and the Service have already drawn the line between testing and research,[2] and the courts have amplified that distinction.[3]

- The Service has told universities which bookstore items can be sold free of tax, and which items generate income subject to tax.[4]

- The Service has already differentiated the untaxed rental of a campus facility from the taxable operation of a summer camp.[5]

- The Treasury, supported by the Supreme Court, has told professional societies what journal advertising is unrelated, and therefore taxable, and what is related.[6]

In these and many other instances, the Internal Revenue Service has demonstrated the ability to "draw the line" between taxable and exempt sales and service activities in accordance with the current law. However, despite this evidence, complaints persist, so this Subcommittee should ask (1) whether the Internal Revenue Service has adequate resources to make the distinctions required by the current law and apply those distinctions to the many different types of exempt organizations currently operating, (2) whether the current law provides adequate guidance to the public and the IRS to resolve the difficult cases, and (3) whether the line which is drawn by the current law is the appropriate one.

As for the adequacy of the current statutory provisions to resolve the "hard cases," most close observers would acknowledge that there are "grey areas" and uncertainties under the current law, especially where rapidly advancing technology alters the type of goods and services traditionally provided by exempt organizations. However, the evidence is clear that most of the factual situations complained of during these hearings have already been addressed by the law, the regulations, the IRS or the courts. Thus, **the area of uncertainty is relatively small.**

Most close observers would also agree that some uncertainty is attributable to the growth in the number and variety of exempt organizations over the past several decades. Although charitable organizations are the largest single group of exempt organizations, there are now 25 separate exemption categories listed in section 501 of the Internal Revenue Code and at least four other statutory subcategories contained within that section. The existing unrelated business income tax law applies to all of these many different types of exempt organizations, from large universities to garden clubs, to veterans organizations, to cemetery companies, and to dozens of other types of organizations. As a result, the existing unrelated business income tax law appears complex and unwieldy to those encountering it for the first time. Wholly apart from the concerns of "unfair competition," there is much that could be done to improve the general clarity and precision of the existing statutory provisions.

But you are not here today to pursue an intellectual exercise or to promote simplification of the tax laws for the sake of simplification. Rather, your questions focus upon the ability of the existing law to curb unfair competition with for-profit enterprises, yet at the same time preserve and foster the activities underlying the exempt status of the dozens of different types of exempt organizations. You have heard, and I would endorse, the proposition that **the current level of activity by the Internal Revenue Service is not adequate to promote a high level of voluntary compliance with the existing law.** The Congress must assist the Internal Revenue Service in allocating its resources, and if the Congress desires a higher level of compliance and enforcement in the unrelated business income area, the Congress should make it possible for the Internal Revenue Service to respond.

Please understand that I am not criticizing the personnel of the Internal Revenue Service, who generally exhibit a high degree of professionalism and care in the enforcement of these laws. However, the Internal Revenue Service as an agency has not devoted the resources to this area comparable to those it has provided to other areas within its responsibilities. For example, the following table summarizes my analysis of the Service's activity in the publication of Revenue Rulings and Revenue Procedures, which are an essential means of communicating to the public the way the Internal Revenue Service interprets current law:

REVENUE RULINGS AND REVENUE PROCEDURES PUBLISHED[7]

Fiscal Year	Total	Exempt Organizations	Unrelated Business Income
1987 (first 6 months)	89	1*	0
1986	211	15*	0
1985	259	6	3
1984	269	10	0
1983	297	5	0
1982	330	14	1
Totals	1,455	51	4

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* Includes administrative rulings, separately tabulated in earlier years.

I believe that, upon reflection, you would conclude that most of the highly emotional public responses to IRS administration in recent years, other than the recent W-4 controversy, have dealt with subjects administered by the Exempt Organizations personnel of the Service. Private schools, women's rights and anti-abortion groups, political activities and unjust personal enrichment from charitable funds are all subjects about which the public cares deeply. This means, I believe, that the administration of the laws governing exempt organizations cannot be evaluated fully by the normal quantitative measures of tax revenues collected, returns audited, or personnel employed. Rather, both a quantitative and a qualitative evaluation are required.

In quantitative terms, the Commissioner may tell you that the Service has an adequate numer of personnel to administer exempt organizations and the taxation of their unrelated business income. I believe that data such as the "rulings published" numbers shown above will reveal that the IRS is not devoting sufficient resources to educating the public, through Revenue Rulings or other means, which is an essential element in promoting voluntary compliance. As for enforcement activities, it may be true that a greater percentage of exempt organization returns are audited than individual and corporate returns. However, these hearings suggest that audit coverage is either not extensive enough or not focused enough to deal with reported instances of noncompliance. I believe that the Service has recognized that its audit procedures may not be as well designed as possible, for it has recently announced a plan to conduct an in-depth examination of a selected sample of 3,000 unrelated business tax returns. I understand that the actual audits will begin this Fall and are scheduled to be completed by the Spring of 1989. This effort should lead the IRS to identify methods for conducting more effective audits of unrelated business tax returns, as well as to judge how high a level of compliance actually exists.

You have also heard that there is a relatively small body of data concerning the revenue-generating activities of exempt organizations, and the studies of the SBA and GAO confirm this testimony. The special additional audit of unrelated business tax returns by the IRS will provide additional information which should significantly expand the body of knowledge. However, the Service should be encouraged by the Congress to do more with available data, as well as to redesign the existing returns in ways which will enable a better analysis of the questions you have encountered during these hearings.[8/]

In addition to undertaking a more careful and thorough examination of the revenue-generating activities of exempt organizations, I believe that you should be somewhat skeptical of the assertions that a significant tax disparity exists between unrelated businesses of exempt organizations and independent, for-profit undertakings. In my experience, the majority of those activities I would describe as "small business" are not conducted in a form which subjects the income to corporate income tax. Rather, those small busineses are formed as proprietorships, partnerships, or S corporations, none of which is subject to the corporate income tax. As a result, I believe that careful investigation would reveal that, in many situations, the federal tax burden borne by an unrelated business activity of an exempt organization is higher than the federal tax burden borne by a competing, for-profit enterprise. The wages and salaries of the employees are, of course, subjected to the same tax rates regardless of the nature of the employer. By these observations, I do not minimize the legitimate complaints of small businesses which may exist, but the magnitude of any disparity may well be significantly overstated by a focus upon isolated situations. On this point, it would helpful to have the Treasury and Service, with public participation, conduct a comparative analysis of actual tax burdens, under current income tax laws, of competing for-profit businesses and unrelated businesses of exempt organizations.

If the Congress wishes to refine the existing law in order to eliminate undue complexity or uncertainties and curb possible excesses, a list of suggestions for your closer examination would include:

1. Convenience exception. The statutory convenience exception could be clarified to limit its applicability to those items which serve the convenience of the member or other "participant" in a way which contributes to advancing the organization's exempt purposes.

2. Governmental activities. The Congress has expressly subjected state colleges and universities to the unrelated

business income tax,[9] but other state and local agencies are subjected to tax only on income derived from a "non-essential governmental function."[10] There are no Treasury Regulations interpreting this terminology, and there is little evidence of efforts by the IRS to impose tax on the income of "non-essential governmental functions" of state and local agencies. Because you have received complaints of competitive activity by state and local agencies, it would be appropriate to examine these situations and, if unfair situations actually exist, to propose extending the unrelated business income tax provisions to these agencies.

3. Indirect expenses. The existing law precludes the deduction of indirect expenses from gross unrelated business income.[11] The application of this principle by the IRS appears to be unfair to the exempt organization if the test of fairness is to be an equality of tax treatment with the independent business.

4. Efficient operations. There are some assertions by the IRS that the use of efficient managerial techniques in revenue-generating functions is evidence that an activity is unrelated. The Congress presumably does not want hospitals, universities and other exempt organizations to operate in an inefficient fashion in order to remain exempt. Although a statutory refinement on this point may be too complex, it may be appropriate for the Committee or the Congress to direct the Treasury Department to revise its regulations to provide unambiguously that efficient operations are not evidence of an unrelated activity, but that operations undertaken without regard for the organization's mission are evidence of unrelated and potentially taxable activities.

Undoubtedly, there are many other areas of uncertainty which could be effectively addressed by the Congress, while preserving the basic structure of existing law. If, however, this Subcommittee concludes that the existing law is not working satisfactorily and should not be preserved, other approaches are possible and have been suggested by the testimony you have heard. One approach would be to eliminate the unrelated business income tax altogether and to impose tax only upon unreasonable accumulations of earnings by exempt organizations. As you know, for business corporations, there is a special tax, the accumulated earnings tax, which is imposed upon business corporations if their accumulations of earnings are beyond the reasonable and reasonably anticipated needs of the business.

An unreasonable accumulations tax could be designed as a substitute for the current unrelated business tax law if you believe that the problem is not the day-to-day activities of exempt organizations, but rather the "predatory" activities of institutions with large accumulations of wealth. However, in the interest of historical completeness, I would note that the Internal Revenue Code did contain a prohibition upon unreasonable accumulations prior to 1970. When the Congress rewrote a large portion of the law dealing with charitable organizations in the Tax Reform Act of 1969, the provision prohibiting unreasonable accumulations was deemed unnecessary for organizations other than private foundations, and therefore was eliminated from the Code.[12]

The 1969 judgment of the Congress appears to remain valid, for experience shows that the trustees of endowed institutions struggle constantly to balance the need for current operating expenditures against the need to provide for future operations for new generations of students, patients and other beneficiaries of their efforts. Moreover, since the present complaints of unfair competition seem to have arisen with greater frequency as exempt organizations have sought additional revenues to maintain their existing operations, it is doubtful that the real concerns could be addressed by an unreasonable accumulations tax structure.

Another new structure which could be devised would be the **development of different standards for different types of organizations.** For example, many commentators have attempted to separate the existing types of exempt organizations into two general categories, the **public benefit** organizations and the **mutual benefit** organizations. In fact, the existing law already contains a significant differentiation of this type. Social clubs, voluntary employees' beneficiary associations ("VEBAs"), supplemental unemployment benefit trusts, and group legal services plans are subjected to unrelated business tax under a different standard from that applied to charities, unions, trade associations and the other section 501 organizations.

For social clubs and the three other specific categories of mutual benefit organizations, all income is subject to income tax unless it is "exempt function income," which includes dues, fees and charges paid by members for the goods or services provided in discharging the organization's exempt purpose.[13] It would be possible to extend this concept to other exempt organizations which primarily provide specific goods and services to individuals, such as fraternal benefit societies, teachers' retirement fund associations, cemetary companies and credit unions. However, considerable disagreement would arise over the proper classification of some organizations, such as community hospitals and unions, which provide services to specific individuals but which serve broader social objectives. Indeed, it can be argued that any self-help organization, with the possible exception of social clubs, fulfills important societal functions and should not be treated less favorably than churches, museums, and social welfare organizations. It also seems likely, although I have no real evidence, that most mutual benefit organizations, with the possible exception of hospitals and unions, do not engage in a large volume of the type of business activities which stimulate complaints. For the Subcommittee to propose an expansion of this "public benefit/mutual benefit" distinction would probably produce great public controversy without a corresponding benefit in reducing complaints of unfair competition.

Another distinction which might be attempted would be to **separate the existing organizations into those which are primarily publicly supported and those which are supported primarily by revenues from the sales of goods and services.** Many citizens would probably agree, in concept, that an organization which generates the great majority of its financial support from the sale of goods or services to the public should have a lesser degree of exemption from taxation than an organization which is largely supported by contributed funds. Thus, these citizens would probably agree that a traditional church should be allowed a greater range of tax-exempt activity than a self-supporting low-cost housing provider, for example. However, the concept becomes much more difficult to apply if the sales revenues come not from the general public, but from a discrete group of "participants" in the organization's activities, such as university tuitions from students, hospital fees from patients, or dues from union members. It is not clear that these "participant supported" organizations should, in the minds of most citizens, be subjected to a greater incidence of taxation than "contribution supported" organizations. Indeed, there is some evidence that the public prefers many "contribution supported" organizations to become more self-supporting by charging for their goods or services where appropriate.

Thus, it would appear likely that if a "sales revenue supported" classification were to be developed, in order that organizations of that type could be subjected to greater taxation than "contribution supported" organizations, a distinction between "related" and "unrelated" revenues would be required to protect from undue taxation organizations which have traditionally been supported by tuitions, fees, dues and similar payments. It would then be possible to tax an organization which is principally supported by "unrelated revenues" on all of those unrelated revenues. But this would simply bring us to the same issue we have today, the need to give substance to the term "related" in a way which can be applied to dozens of different types of organizations.

Some have suggested that a new standard for taxability is needed because of the "vagueness" of the "substantially related" standard. Once again, history is instructive. While the Congress clearly was motivated in 1950 to eliminate "unfair competition," it realized that the term "unfair competition" has an uncertain and variable meaning, and the Congress also clearly did not intend to tax "traditional" revenue-generating activities, even if they were competitive with non-exempt businesses. The original definitional content of the term "substantially related," as expressed in the original administrative interpretations, was that a business was unrelated if its income was **disproportionate in amount** to the exempt activities of the organization, or if the **primary purpose** of the business activity was the **production of income**, or if the business was **operated in the same manner as a commercial business.**[14] Following a series of judicial decisions concluding these standards to be incompatible with the statute and its legislative history, the Treasury significantly revised the regulatory interpretation of "substantially related" in 1967. Those regulations, which remain in effect today, treat as unrelated those activities which do not "contribute importantly" to the performance of the exempt function of the exempt organization.[15]

By now, there is a reasonably consistent and settled body of law articulating what is meant by "substantially related," including a 1986 Supreme Court decision.[16] To substitute a new standard at this point would be to discard four decades of legislative, administrative and judicial effort and to begin anew the interpretative process for the new statutory articulation. Moreover, my impression of the testimony is that few of the activities complained of are those where it is hard to apply the current statutory standard. Rather, the complaints generally reflect either a lack of enforcement of existing standards -- unrelated travel or tour services, unrelated testing services, and unrelated merchandise sales, for example -- or a disagreement with existing policy decisions, *e.g.*, to encourage scientific research by expressly exempting it. Consequently, it appears unproductive to attempt to substitute a more certain articulation for "substantially related."

If, however, a different tax result is desired for policy reasons, the law could be revised to utilize **"competitive effect" either as an additional criterion for taxation, or as the sole criterion.** Some have suggested that the only need is to regulate activities which are competitive with for-profit undertakings. Therefore, the law should only tax those organizations which are, in fact, in competition with a for-profit business. Thus, "competitive effect" could be required for taxation of an unrelated business activity or a "competitive effect" could be used as evidence of the unrelated nature of a particular activity, along with all of the factors now considered. More radically, it would be conceptually possible to impose tax only upon revenues when the activity is actually competitive with a for-profit enterprise or even to prohibit such activities altogether.

To devise a workable new standard, the Congress could provide for the taxation or prohibition of activities by exempt organizations which created "substantial competitive harm" for a for-profit business. The burden would be on the complaining business to initiate the process and produce evidence that a new or expanded activity of an exempt organization was the direct cause of a quantifiable loss suffered by the for-profit business. In fairness to existing activities, only activities initiated or expanded by exempt organizations following enactment of this new system would be subject to it.

A change of this type would have significant consequences, both for the federal government and for exempt organizations. For the government, this would necessitate the creation of a group of personnel, either in the IRS or another agency, who are trained and provided with the resources to make antitrust-like analyses of market competition between revenue-generating activities of an exempt organization and an independent, for-profit business. This new staff would have to go beyond an examination of the activities and purpose of the exempt organization to an examination of the business operations of the complainant, after determining whether a community, city, state or national market was the "relevant market."

If existing activities were not "grandfathered," such a new system would mean that many current related activities might become taxable, or prohibited, but that many unrelated activities might become exempt. The standard would produce major disruptions, for traditional activities could become taxable if a for-profit competitor should enter the market. Major investments in facilities and equipment by exempt organizations could be made obsolete. Correspondingly, if a for-profit supplier of goods and services should go out of business or otherwise cease operating, the exempt organization might once again be called upon to make the necessary investment to provide the goods or services needed by its students, members or other beneficiaries of its exempt functions.

While such a new approach is intellectually interesting, this Subcommittee should proceed cautiously in evaluating it, given the absence of a sound base of information and the obvious governmental costs and market dislocations which such a system would produce. It may be that this is the only type of system which can be expected to respond effectively to repeated changes in our economy and institutions, but far more evidence than that currently available is needed to warrant such a drastic change of direction.

Finally, this Subcommittee could decide that the problem of a "competitive effect" could be addressed by requiring that the taxable subsidiaries and joint ventures of exempt organizations be required to pay a "market return" to the exempt organization. The suggestion here would be that income taxation is not the real problem; rather, it is "free capital" that causes unfair competition. In my experience, exempt organizations have formed taxable subsidiaries for a variety of reasons, including:

- The desire to "consolidate" all taxable activities in a single taxable unit which files a regular corporate income tax return, thereby eliminating the need to file a Form 990-T unrelated business income tax return for the exempt organization.

- The desire to place a group of "business specialists" in charge of the subsidiary's operations and not burden the trustees of the exempt organization with the managerial and financial details of the unrelated business activity.

- The desire to utilize business compensation techniques for the employees of the admittedly unrelated activity, such as bonuses and other forms of incentive compensation and deferred compensation, without the limitations imposed on exempt organizations.[17]

- The desire to be able to reflect fully the indirect, overhead expenses of operations in computing net income, which is not allowed for unrelated business not separately incorporated.[18]

- The ability to utilize accelerated depreciation or cost recovery methods when borrowed funds are involved, which is not allowed for exempt organizations.[19]

However, the use of subsidiaries is not new, for the Congress was responding to the use of separately-incorporated businesses when it enacted the original unrelated business income tax law in 1950. The so-called "macaroni monopoly" involved the operations of a separate business corporation beneficially owned by a university, and the same university owned an automotive parts company, a china company and a leather company.[20] The Congress responded by enacting both the unrelated business income tax laws and the "feeder organization" rules, the latter of which specifically treat as taxable any subsidiary which is engaged in a business (with minor exceptions).[21] Thus, there is nothing either new or mysterious about the use of one or more subsidiaries by a university, a hospital or other exempt organization.

Similarly, there is nothing improper or devious about joint ventures or partnerships. If a partnership is carrying on an unrelated business, an exempt organization partner is subject to tax on its share of the partnership's income,[22] and the IRS has developed standards to prevent improper private enrichment.

It is highly unlikely that any significant number of exempt organizations would use a taxable subsidiary or a partnership to provide unjust benefits or a "sweetheart deal" to their managers, employees or "friends." Instead, "real world" pressures compel exempt organizations to bargain for market rates of return from their partners and their subsidiaries. Moreover, the IRS has the full range of traditional audit tools available to correct improper cost or income allocations and to require the use of accounting techniques which accurately reflect taxable income.[23] Consequently, there appears to be little to be gained from an enactment of a statutory "market return" requirement.

RECOMMENDATIONS

Based on my experiences and the testimony you have received, I recommend the following three actions for your consideration:

1. **Encourage the Internal Revenue Service to develop personnel and budgetary recommendations for an enhanced enforcement and educational effort and support such proposals in the Congressional budgetary process.**

The IRS should be encouraged to "upgrade" the quality of its Exempt Organizations personnel, especially at the "field" level. The Service should not allow all of its most qualified employees to be diverted to the corporate and individual income tax functions, either by "self-selection" of career paths or by encouragement from supervisors. The recruitment and retention of highly capable employees for the Exempt Organizations function should become a higher IRS priority if the Congress is seriously interested in adequate enforcement.

In addition, I believe that significant increases in voluntary compliance would result from an expanded program of publishing Revenue Rulings in the exempt organizations and unrelated business income tax areas. In addition, more general explanatory materials directed to the general public would be of assistance. Currently, the Service provides for its own personnel an Exempt Organizations Guide as part of the Internal Revenue Manual and prepares annual "training manuals" for the continuing education of its Exempt Organization specialists. These materials often provide excellent analytical examinations of unrelated business tax issues, but these materials are not generally accessible by members of the general public and are written for tax law specialists. A more general "guidebook," written to explain the positions of the IRS to the general public, would encourage proper reporting of unrelated business income.

However, these and other similar enforcement and informational activities consume resources, and the current IRS budget apparently does not allow the Service the ability to provide these expanded activities. Therefore, either a reallocation of resources or an increase in resources would be needed to carry out this recommendation, and this Subcommittee can initiate such actions.

2. **Direct the Treasury and the Internal Revenue Service to expand their information-gathering techniques, to prepare a more comprehensive study of the nature and extent of the revenue-generating activities of exempt organizations, and to contrast the federal income tax burdens of taxable unrelated business activities of exempt organizations with those of independent, for-profit proprietorships, partnerships, S corporations and C corporations engaged in the same types of business.**

For the reasons described earlier, both the Form 990 and the Form 990-T should be redesigned to elicit greater information. With increased data, and with an unbiased analysis of actual comparative tax burdens under current law, this Subcommittee will be better able to consider proposals for significant changes in the current law.

3. **Direct the Treasury to reconsider and report to the Committee concerning the statutory provisions and Regulations dealing with the convenience exception, state agencies, indirect expenses, and the "efficiency" factor.**

As discussed above, these provisions of current law, or their administration, appear to warrant additional attention. It may be that possible excesses, by either the Service or exempt organizations, can be best addressed by Regulations or Revenue Rulings. If so, those administrative responses should occur with reasonable promptness. If a change is warranted, but an administrative response is not feasible, by reason of earlier Congressional sanction or otherwise, a recommendation for legislative action should be provided by the Treasury.

If my impressions are correct, these three actions should either substantially reduce the assertions of unfair competition or clearly identify those areas of inadequacy of the current law. If the latter appear, the Subcommittee would have a reasoned basis for proposing specific legislative changes to the Committee.

FOOTNOTES

1/ *See*, *e.g.*, Rev. Rul. 78-43, 1978-1 C.B. 164.

2/ Treas. Reg. § 1.501(c)(3)-1(d)(5)(ii); Rev. Rul. 78-426, 1978-2 C.B. 175; Rev. Rul. 68-373, 1968-2 C.B. 206; Rev. Rul. 65-1, 1965-1 C.B. 226.

3/ *IIT Research Institute v. United States*, 56 A.F.T.R. 2d 85-6023, 85-2 U.S.T.C. ¶ 9734, 9 Cl. Ct. 13 (1985); *Midwest Research Institute v. United States*, 554 F.Supp. 1379 (W.D. Mo. 1983), *affd*., 744 F.2d 635 (8th Cir. 1985).

4/ Private Letter Ruling 8004010 (technical advice); G.C.M. 35811 (May 7, 1974).

5/ *See*, *e.g.*, Rev. Rul. 76-402, 1976-2 C.B. 177, *amplified in* Rev. Rul. 80-297, 1980-2 C.B. 196; Private Letter Ruling 8151005 (technical advice); Private Letter Ruling 8136028 (technical advice).

6/ *United States v. American College of Physicians*, 475 U.S. __, 106 S. Ct. 1591 (1986); Treas. Reg. 1.513-1(d)(4)(iv) *Example (7)*.

7/ "Total" and "Exempt Organizations" columns taken from IRS Commissioner and Chief Counsel's Annual Reports for the relevant years (and IRS public information office for 1986 and 1987); "Unrelated Business Income" column derived from an individual examination of each year's Cumulative Bulletin or Internal Revenue Bulletins.

8/ For example, the 1986 Form 990, in Part VII, asks a reporting organization to "attach a statement explaining your reason for not reporting" on the Form 990-T return "any gross sales or receipts from business activities" which are not reported. It would be more useful to require a statement of the amount of such receipts and the specific statutory basis for non-reporting, *e.g.*, one of the research exemptions, the convenience exception, or the "substantially related" nature of the activity.

9/ Internal Revenue Code § 511(a)(2). The constitutionality of the unrelated trade or business income tax as imposed on state colleges and universities was upheld in *Iowa State University of Science & Technology v. U.S.*, 500 F.2d 508 (Ct. Cl. 1974), involving income from the ownership and operation of a commercial television station.

10/ Internal Revenue Code § 115.

13/ Internal Revenue Code § 512(a)(1); Treas. Reg. § 1.512(a)-1.

12/ *See generally* *General Explanation of the Tax Reform Act of 1969* (Staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970), at 36-37 n. 10.

8/ Internal Revenue Code § 512(a)(3).

14/ Section 39.422-3(a)(4) of Federal Tax Regulations 118, 26 C.F.R. (1954), under the 1939 Code, made applicable to the 1954 Code by Treasury Decision 6091, 1954-2 C.B. 47. *See*, *e.g.*, Rev. Rul. 57-313, 1957-2 C.B. 316.

10/ Treas. Reg. § 1.513-1(d)(2).

18/ *American College of Physicians*, *supra* n. 6.

19/ Internal Revenue Code § 457.

18/ *Supra* n. 11.

19/ Internal Revenue Code § 514(a)(3).

20/ *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951).

21/ Internal Revenue Code § 502.

22/ Internal Revenue Code § 512(c).

23/ Internal Revenue Code §§ 446, 482; Treas. Reg. § 1.511-3(c).

Mr. JACOBS. Ms. Rose-Ackerman.

STATEMENT OF SUSAN ROSE-ACKERMAN, ELY PROFESSOR OF LAW AND POLITICAL ECONOMY, COLUMBIA UNIVERSITY

Ms. ROSE-ACKERMAN. As public policymakers considering the impact on the economy of the unrelated business income tax on nonprofit corporations, we must be careful not to let the terms of the debate be determined by the various producer groups that are involved, whether they are small business firms or nonprofit institutions. Instead, we should look to the consumer's interest in competition with respect to variety, quality and price. Generally, consumers are benefitted by vigorous competition, and we must be careful to ask whether claims of unfairness are made by firms simply seeking to preserve excess profits at the expense of the consumer. A market with many firms usually serves consumer interests better than one with few firms.

My basic argument is that Congress should be skeptical of claims of unfair competition. Such language has been too often used in other contexts to limit entry, preserve monopoly power, and harm consumers. However, a broader look at the process of granting charitable status may be in order, so long as it is carried out consistently with the preservation of the widespread ideological diversity of the nonprofit sector, a diversity that cannot be matched within either the Government or the for-profit sector, and that is an integral part of the ability of U.S. society to absorb people of sharply contrasting beliefs, habits, and preferences.

Starting with a presumption in favor of vigorous competition, the questions for Congress are three in number. First of all, does the tax-exemption for nonprofits' related commercial activities lead to an inefficient distribution of production between nonprofit and for-profit providers?

Secondly, are for-profit firms being unfairly asked to bear part of the burden of the subsidy of charitable organizations that should be borne by society at large?

And thirdly, how should the U.S. Government decide which activities deserve tax-exemption in the first place?

I want to talk about the efficiency and fairness issues together. Under certain plausible conditions, a tax that is levied as a percentage of profits will not affect an individual firm's price and output decisions. The only difference between the firms is that the tax-exempt entity is making more money. Thus, even though a nonprofit is exempt from income taxes, it will not necessarily act any differently in the market than a taxable for-profit firm.

What, then, do the for-profits have to complain of? Possibly this: Over the long run, there could be so much entry of nonprofit's into a particular industry that the rate-of-return falls and causes the exit of some marginal for-profits. The for-profits which exit may feel unfairly treated if they have industry-specific capital and good will that cannot easily be transferred into other occupations. Part of the costs of the public policy in favor of aiding charity is then being concentrated on this particular group of for-profits.

However, this potential for harm may not create an important public policy problem since there are three arguments which suggest that instances of this kind of unfairness will be rare.

First, if the for-profit firms were earning more than a competitive rate of return before entry, there is little reason for public concern. Individual firms suffer harm, but the industry is more competitive and serves consumer interests' better than before the entry of the nonprofits.

Second, the entry of nonprofits into commercial ventures will be limited by their limited access to capital.[1] They, after all, cannot make use of equity financing, and must diversify their investments to reduce risk. And third, in some situations, nonprofits may be the most efficient providers because they can make use of underutilized resources acquired for other purposes. If they then charge lower prices because of this, this only reflects their greater efficiency.

Nevertheless, Congress should recognize that where the unexpected large-scale entry of nonprofits into particular businesses is a problem, then it may be exacerbated by the UBIT which induces nonprofits, to invest in those areas which IRS defines as related. A more permissive definition of related, or repeal of the UBIT, could actually aid for-profits by diffusing nonprofits investment more broadly so it would have little impact on the rate of return in particular lines of business.[2]

My final point concerns the criteria for determining whether an institution should be granted a tax-exemption. We should be careful to separate this issue from the question of competition between nonprofits and for-profits, in cases where no one is challenging the basic charitable purpose of the nonprofit.

Certainly there is a valid public policy concern if a nonprofit's manager and staff are spending a high proportion of their time running moneymaking ventures with little or no charitable value. Publicly beneficial purposes may then take a back seat to the simple desire for growth and wealth accumulation, even if none of the principals can legally share in the firm's profits. Questions have been raised about hospitals that have no teaching or research activities, and only accept fee-paying patients, or about YMCAs in wealthy communities that do little more than operate health clubs for well-to-do members. However, as I have pointed out before, it is not obvious that such organizations will harm for-profits with price-cutting strategies unless they do in fact have an efficiency advantage. Thus, no issue of unfair competition need arise. The nonprofit organizations are competing, but their competition is not unfair. Nevertheless, one can legitimately ask if such organizations should be tax-exempt in the first place. And I do want to stress, that I think it is very important to separate the question of the validity of the tax-exemption for certain kinds of organizations and from the question of unfair competition between nonprofits and for-profits in other areas. Thank you.

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[1] See Henry Hansmann, "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation," Yale Law Journal 91:54-100 (1981). Reprinted in S. Rose-Ackerman, ed., The Economics of Nonprofit Institutions: Studies in Structure and Policy, Oxford Univ. Press, N.Y. 1986, pp. 367-394.

[2] For a fuller exposition of this point see Susan Rose-Ackerman, "Unfair Competition and Corporate Income Taxation," Stanford Law Review, 34:1017-1039 (May 1982). Reprinted in Rose-Ackerman, supra pp. 394-414.

Mr. JACOBS. Thank you. Mr. Hansmann.

STATEMENT OF HENRY HANSMANN, PROFESSOR, YALE LAW SCHOOL

Mr. HANSMANN. Thank you. There has of course been considerable agitation in the business community for more rigorous application of the unrelated business income tax, or UBIT, to use the unlovely acronym.

On the other hand, there has been some prominent support in the scholarly community for the partial or complete repeal of that tax, and in light of this controversy, I would simply like to offer here my own view that there are in fact very strong economic arguments for retaining the UBIT in roughly its present form.

The basis of those arguments, however, does not principally lie in the complaint that is most often heard from the small business community, which is namely, that the unrelated business activities of nonprofit organizations will impose large competitive losses upon for-profit firms.

To begin with, there is good reason to believe that such losses would not be large, even without the UBIT. But more importantly, even if elimination of the UBIT would impose no competitive losses whatsoever on existing for-profit firms, there would still be a strong argument for the preservation and consistent application of the UBIT. And that would be on grounds of economic efficiency. Without going into detail here, I will briefly summarize the most important efficiency arguments.

First, nonprofit firms may often be less efficient than for-profit firms in managing unrelated businesses. Tax exemption, however, allows nonprofit firms to survive in competition with for-profit firms, even where the nonprofits are operating at higher cost. Consequently, to grant a tax exemption to nonprofits to operate businesses for which the nonprofit corporate form has no nontax advantages is to encourage a potentially inefficient organization of industry.

Second, without the UBIT there would be a serious disparity in tax treatment between businesses that are wholly owned by nonprofits and businesses in which nonprofits simply own some shares of stock. There would thus be a strong incentive, for example, for endowed institutions, such as universities, to sell off their stock and invest entirely in wholly owned businesses, and this, in turn, could lead to very poorly diversified portfolios for the institutions involved.

Third, and finally, tax exemption for unrelated businesses is a form of subsidy to nonprofits that is very poorly related to the needs of the organizations involved. In fact, arguably, it would generate the largest subsidies for the nonprofits that are least in need.

Now, having said all this, it remains to ask how we should determine whether a business is in fact "related." I believe that the largest area of uncertainty here involves those activities that, though otherwise not directly related to a nonprofits exempt functions, exhibit what economists would call economies of scope.

These are those activities that, though otherwise unrelated, are less costly when undertaken jointly with a nonprofit's other clearly exempt activities. The provision of meals and lodging for graduate students at a university is perhaps an example, but there are many others.

There are a variety of competing arguments concerning the desirability, from an economic point of view, of taxing the returns from such activities that exhibit economies of scope. Fortunately, there is little need to weigh these arguments very closely. Nonprofits will often undertake these activities whether they are taxed or not. Thus the Tax Code can draw a fairly arbitrary line here between those activities that are subject to the UBIT and those that are not, without being terribly concerned that much depends on precisely where that line is drawn.

To take an example, there is probably little reason to worry deeply whether we should or should not tax the income universities get from selling personal computers to their faculty and students.

In short, there is good reason to believe that the UBIT, as presently defined, is basically sensible. Many of the hard cases that the Treasury is struggling with—and I might say I think thoughtfully struggling with—are precisely where you would expect to find them, namely, in those otherwise unrelated activities that exhibit economies of scope, and, fortunately, not a great deal depends on how those particular hard cases are resolved.

But it seems to me that where tax-exemption for nonprofit organizations are concerned, the UBIT is largely a side show. The more important issue, and the one that is becoming increasingly difficult to avoid, is the appropriate scope for the basic section 501(c) exemption itself.

I believe that it is time to think harder about the classes of nonprofit organizations that should qualify for this exemption. The most troublesome classes of nonprofits from this perspective are the so-called commercial nonprofits. These are nonprofits that derive substantially all of their income simply from the prices they charge for the goods and services they produce, and receive no meaningful amount of donative support. For example, today most nonprofit hospitals, nursing homes, health-maintenance organizations, day-care centers, and summer camps would probably fall within the category of commercial nonprofits.

In my written testimony I describe some principles for determining whether particular classes of commercial nonprofits merit exemption. Let me merely say here that there is some reason to believe that there are various industries in which commercial nonprofits are common today but are essentially anachronistic.

These are industries in whose formative stages nonprofit firms played a vital role. Once these industries became well established, however, for-profit firms were able to produce the services involved quite adequately yet, through historical inertia, the nonprofits remained.

There is no reason to drive the nonprofits out of such industries today, but neither is there any reason to subsidize them.

This description seems to fit the nonprofit insurance firms from which Congress withdrew exemption in 1986. Arguably, it also describes the hospital industry today, and it may describe most other industries in which commercial nonprofits are common. There may, then, be good reason to reconsider whether tax exemption is appropriate for nonprofits in some of these industries.

Thank you.

[The statement of Mr. Hansmann follows:]

THE APPROPRIATE SCOPE OF TAX EXEMPTION FOR NONPROFIT ORGANIZATIONS

Henry Hansmann
Yale Law School

Statement Prepared for Hearings on the Unrelated Business Income Tax Before the Subcommittee on Oversight of the Committee on Ways and Means, U. S. House of Representatives, June 30, 1987.

Mr. Chairman and Members of the Committee:

I would like to focus my remarks on some broad policy issues underlying corporate income tax exemption for nonprofit organizations. These remarks will be divided into two parts. First, I shall discuss the policy rationale for the unrelated business income tax (UBIT), which has been a source of controversy recently and which is a principal focus of these hearings. Second, I shall discuss the rationale for tax exemption for nonprofit organizations in general, and suggest some guidelines for deciding whether the current broad scope of the exemption should be narrowed.

I shall keep my remarks relatively brief and general. Elsewhere I have written in more detail about some of the issues involved here.[1]

I. The Unrelated Business Income Tax

There has been considerable agitation from the business community recently for stricter application of the UBIT in order to reduce what is seen as unfair competition for small business from nonprofit firms. In the light of this, it is interesting to note that there is prominent academic commentary calling not for greater rigor in the application of the UBIT, but rather for its complete repeal.

My object here is simply to suggest that careful economic analysis in fact supports the conventional wisdom of the business community: the UBIT helps to assure that nonprofit firms do not have an undesirable competitive advantage in providing services that can be provided as well or better by for-profit firms. It

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1. Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L. J. 69 (1981); Hansmann, Unfair Competition and the Unrelated Business Income Tax (Unpublished, 1987).

also helps to avoid some other unwanted investment incentives that nonprofits would face in its absence.

In discussing the UBIT, it is helpful to divide the unrelated business activities of nonprofits into two categories. First, there are those business activities that, while not directly related to the exempt purposes of the nonprofit in question, exhibit what economists call "economies of scope" -- which is to say that they are less costly when undertaken in conjunction with the nonprofit's other, related services. The food and lodging that a university provides for graduate students probably falls in this category. Second, there are those activities that exhibit no such economies of scope -- that is, in whose management the nonprofit in question has no natural cost advantages. A macaroni factory operated by a university would be an obvious example. I shall first focus on activities that fall into the second of these categories. In a later section I shall discuss those activities that exhibit economies of scope.

A. The Competitive Impact of Unrelated Business Activities

Although there is a strong policy rationale for the UBIT, its principal basis does not lie in the complaint most often heard from the business community -- namely, that the unrelated business activities of nonprofit organizations will impose large competitive losses upon for-profit firms and perhaps drive them out of business. To be sure, without the UBIT at least some for-profit firms might suffer this fate. But there is good reason to believe that nonprofit organizations would not in general respond to the absence of the UBIT by entering profit-making activities in such a fashion as to impose substantial losses upon existing business firms. A nonprofit has an incentive to get the highest return possible per dollar invested in its unrelated business activities. This result would not be accomplished by entering a given business so rapidly, and on such a large scale, as to drive down price sufficiently to push for-profit competitors quickly out of business. Rather, tax-exempt nonprofit firms would have an incentive to enter into unrelated businesses at a gradual pace in order to maintain prices at roughly their existing level -- at which nonprofits presumably earn a profit at least equal to the amount of taxes that would otherwise have to be paid. Indeed, the most profitable way for a nonprofit to enter most businesses might well be for it simply to purchase an existing business that is currently operated on a proprietary basis. As a consequence, the absence of the UBIT might in some cases actually increase the market value of proprietary firms in industries that nonprofits choose to enter.

But even if elimination of the UBIT would impose no competitive losses whatever on existing for-profit firms, there would still be a strong argument for its preservation and consistent application on grounds of economic efficiency.

B. The Efficiency Rationale for the UBIT

There are three important reasons why it is economically inefficient to grant tax exemption to the unrelated business activities of nonprofit organizations.

First, it is quite possible that nonprofit organizations will often manage unrelated businesses less efficiently than would for-profit firms. Tax exemption allows nonprofit firms to survive in competition with for-profit firms even where the nonprofits are operating at a higher cost. Consequently, to grant a tax exemption to nonprofits to operate businesses for which the nonprofit corporate form does not hold special advantages is to encourage a potentially inefficient organization of industry. (See Section II below for discussion of activities in which nonprofit firms do have special advantages.) Indeed, much of the tax revenue forgone by exempting unrelated businesses could simply be lost in this type of inefficiency.

Second, in the absence of the UBIT nonprofits would have an incentive to underdiversify their investments. Without the UBIT, for example, a university would find it more attractive to invest its endowment funds in wholly-owned businesses than to follow the currently prevailing practice of investing in a broad range of common stocks, since the wholly-owned business would be exempt from the corporate tax while the tax would still apply in full to business corporations whose stock is partially owned by a nonprofit. Yet most nonprofits do not have sufficient assets to own in their entirety more than a very small number of businesses -- too few to permit an efficient versification of their portfolio.

Third, tax exemption for unrelated business activities is a form of subsidy for nonprofits that is poorly proportioned to their needs. The ability of nonprofits to make investments in unrelated businesses is, if anything, inversely proportional to their need for subsidy.

Fourth, without the UBIT nonprofit organizations might in fact face an excessively strong incentive to invest in unrelated businesses rather than in production of the services for which they are principally organized -- that is, in their "related" activities. As it is, nonprofit organizations in general show some indications of a tendency toward acquiring excessive financial reserves, thus saving too much of their income and spending too little on the activities for which they were organized. Failure to tax their investments in unrelated activities might further augment this tendency.

Fifth, and finally, without the UBIT much larger consequences would attach to a determination as to whether a nonprofit qualifies for the basic exemption. Difficult and arbitrary judgments would have to be made as to when the volume of unrelated business activity becomes so large as to justify withdrawal of the exemption for the organization as a whole.

C. Determining Relatedness

Having outlined the rationale for maintaining the UBIT, it remains to ask how we are to draw the line between related and unrelated businesses.

The discussion below concerning the rationale for the basic exemption offers some principles for determining which activities in general merit tax exemption when undertaken by nonprofits -- that is, to which activities a business should be related in order to fall within the scope of the exemption. Here I shall simply note that, in determining the degree of "relatedness" necessary for a business to fall within the scope of the exemption, the most troublesome cases are likely to be those in which the business involved, though not deserving of exemption in itself, exhibits economies of scope when undertaken jointly with the parent nonprofit's basic exempt activities.

The argument for applying the UBIT to otherwise unrelated businesses exhibiting economies of scope is essentially the same as that which has been described above for other unrelated businesses: application of the corporate tax helps discourage overinvestment in such businesses, and thus helps avoid the inefficiencies that might accompany such overinvestment. That is, application of the tax helps assure that a nonprofit will undertake the business only when economies of scope are in fact present -- which may be difficult for the IRS to determine objectively in many cases.

On the other hand, it can be difficult to draw the line between those business activities that are related to an organization's exempt functions only by economies of scope, and those that are in fact integrally related to the organization's basic purposes. Food services for college undergraduates, for example, could be seen either way. Moreover, separate allocation of costs for business activities that are related by economies of scope will often be difficult, since shared facilities or other shared overhead expenses are likely to be the source of the economies of scope. And these are both reasons for avoiding application of the UBIT in such cases.

Where economies of scope are truly present, however, a nonprofit is likely to undertake the business with or without the tax. Consequently, application of the tax in such cases should have no direct effect on the allocation of activities between nonprofit and for-profit firms. Thus, in an important respect it does not much matter whether or not the UBIT is applied in these cases. This is comforting, for it suggests that we can -- as we must -- draw a fairly arbitrary line between businesses deemed related and those deemed unrelated without being terribly concerned that much depends on precisely where that line is drawn, so long as the line is drawn somewhere in the middle of those otherwise unrelated activities that exhibit economies of scope. Following this logic, it seems reasonable to try to include within the ambit of the tax all of those unrelated activities that do not exhibit economies of scope, while not going so far as to include business activities that not only exhibit economies of scope, but in fact merit exemption in their own right.

II. The Scope of the Basic Exemption

Although determining the appropriate scope for the UBIT presents some difficult problems, this is today a question of only secondary importance where tax exemption for nonprofits is concerned. The more important issue, and one that is becoming increasingly difficult to avoid, is the appropriate scope for the underlying exemption. That is, what classes of nonprofit organizations in general should qualify for exemption under Section 501(c)?

As in the case of the unrelated business income tax, the central issue involved here is one of efficiency. We run the risk of encouraging an inefficient organization of industry if we grant tax subsidies to nonprofits in industries in which they offer no natural advantages over for-profit firms. Or, to put it another way, there is no point in granting a tax exemption, and thus foregoing corporate income tax revenue, if the result is simply to populate an industry with firms that are no more efficient, and perhaps less efficient, than the firms that would exist without tax exemption. On the other hand, there are presumably industries in which nonprofit firms offer socially valuable services of a kind or quality that are unavailable from for-profit firms. In those cases, granting a tax exemption to the nonprofit firms may help to promote an efficient level of production for the services in question.

In deciding which firms might merit the exemption, it is helpful if we divide nonprofits into two broad groups, which we can label, respectively, "donative" nonprofits and "commercial" nonprofits.[2/] Donative nonprofits are those nonprofits that receive some substantial portion of their income in the form of gifts, grants, or philanthropic contributions. Commercial nonprofits, in turn, are those nonprofits that derive substantially all of their income simply from the prices they charge for the goods and services they produce, and receive no

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2. See Hansmann, The Role of Nonprofit Enterprise, 89 Yale L. J. 835 (1980).

meaningful amount of donative support. For example, today most nonprofit hospitals, nursing homes, health maintenance organizations, day care centers, and summer camps would probably fall within the category of commercial nonprofits.

Generally speaking, donative nonprofits do not currently present difficult problems of policy so far as tax exemption is concerned. For the present, it probably makes sense simply to continue to grant the exemption to virtually all donative nonprofits, at least so long as they receive contributions from a reasonably broad group of individuals or organizations. The reason for this is that most donative nonprofits provide services that benefit a substantial segment of the public and that are generally supplied at an inefficiently low level. More specifically, most donative nonprofits either provide a public good (in the economists' sense of that term) of some sort, such as scientific research or commercial-free broadcasts, or else provide assistance to the poor. The fact that the organization is able to attract contributions can generally be taken as sufficient evidence that the organization's services are of this character. To be sure, there may be donative nonprofits that do not merit exemption, and further refinement of the types of donative nonprofits qualifying for tax exemption may at some point be worthwhile. At present, however, commercial nonprofits present problems that are both more pressing and easier to deal with.

In determining the wisdom of granting exemption to commercial nonprofits of some particular type -- for example, hospitals or nursing homes -- a critical question is whether the nonprofits in question provide a kind or quality of service that is unavailable from for-profit firms in the same industry. If they do not, then the case for tax exemption is quite tenuous. In such circumstances, granting a tax exemption to nonprofit firms will not produce services that would otherwise be unavailable. At most, it will simply produce a larger volume of services at lower cost than would otherwise be available. And if this is what is desired, than we must ask why we do not extend the tax exemption to for-profit firms as well. If the industry is reasonably competitive -- and most industries in which nonprofits have a substantial presence appear to be reasonably competitive -- then the benefits of the exemption should be passed on to consumers by for-profit firms as well as by nonprofit firms. In short, the only circumstances in which tax exemption for nonprofit firms in such an industry seem warranted are those in which (1) the basic service that is being provided by both the nonprofit and for-profit firms is thought for some reason to be undersupplied, and thus in need of a general subsidy, and (2) the industry is not sufficiently competitive to insure that the for-profit firms will pass through the tax exemption to consumers in the form of lower prices. It is not obvious that any industry in which commercial nonprofits play an important role satisfies these conditions. It is therefore very difficult to justify tax exemption for nonprofits in those circumstances where they do not provide services that are any different from those provided by their for-profit competitors.

It may be, however, that there are some industries in which commercial nonprofits provide services that are different from those offered by the for-profit firms in the same industry. In such cases, tax exemption for the nonprofit firms may be justified if two criteria are satisfied: first, the service provided by the nonprofit firms is superior in kind or quality to that provided by for-profit firms; second, the services provided by the nonprofits would be undersupplied without exemption.

We can identify two broad types of circumstances in which nonprofit firms may provide services that are unavailable from their for-profit competitors. The first is where the service in question is characterized by serious problems of asymmetric information between producers and consumers. The second is where the nonprofit firms are engaged in some useful form of cross-subsidization. It is helpful to look at each of these separately.

The problem of asymmetric information arises where, owing to the complexity of the service in question or the circumstances in which it is provided, the consumer is in a poor position to judge the quality, or perhaps even the quantity, of the services being supplied to him or her. For example, it may be that patients in a nursing home, or even their relatives or other persons responsible for them, are sometimes in a poor position to judge the quality of the services being provided by the home. In such cases for-profit firms may have an incentive to exploit their patients by providing sub-standard services at high prices. Nonprofit firms may be more trustworthy in such circumstances owing to the absence of owners who have an incentive to pursue the profits that can be obtained from opportunistic behavior.

There is currently much debate and research being focused on the question of whether, in fact, asymmetric information is a serious problem in those industries in which we find commercial nonprofits, and whether the nonprofit firms in those industries in fact provide better services than do their for-profit competitors. So far, we do not have clear results in most cases. It is perhaps a crude but fair summary to say that in the hospital industry, for example, there seems to be little evidence that quality of service in nonprofit firms is often superior to that in comparably priced for-profit firms, while in the nursing care business there is a bit of evidence, though rather tenuous and indirect, that nonprofit firms in some cases are more trustworth than comparably priced for-profit firms.

Even if nonprofit firms in a given industry, such as nursing care, do serve as a helpful antidote to problems of asymmetric information for some consumers, it does not necessarily follow that tax exemption for the nonprofits is appropriate. Those consumers who wish the extra fiduciary qualities of nonprofit firms can choose to patronize such firms; others, perhaps more confident in their ability to police the quality of services on their own, can choose proprietary homes. So long as there is an adequate supply of both types of homes, the market might be expected to work reasonably well without special subsidy to the nonprofits. If there is any case to be made for tax exemption in such circumstances, it should probably be based on the problems that nonprofits have in raising capital. When demand for a particular type of service is growing rapidly -- as it was for nursing care for the elderly in the 1960s and 70s -- nonprofit firms may have difficulty in expanding their services rapidly enough to meet that demand owing to the fact that they cannot obtain equity capital, but rather must rely upon debt and retained earnings for financing. Because corporate income taxation would reduce the amount of retained earnings that a nonprofit could accumulate, it could further impair the difficulties that nonprofits might have meeting demand in their services. Whether undercapitalization of nonprofit firms is a serious problem in any of the industries in which commercial nonprofits are common remains an open question, however. Moreover, tax exemption is an extremely crude way of dealing with this problem. Federal grants and guaranteed loans, as under the now-defunct Hill-Burton program for hospitals, would constitute a much more direct approach.

Another socially beneficial role that commercial nonprofits may play is to engage in cross-subsidization among the services they offer. In particular, it is often argued that many nonprofits, such as hospitals, use the income they derive from their profitable services to finance other services that operate at a loss but are socially useful, such as services for the poor or services of broad benefit to the public at large. To apply the corporate income tax to such organizations might decrease the amount of profits available for such desirable forms of subsidization.

There are, however, several possible objections to this argument for tax exemption. First, it is not clear how much socially useful cross-subsidization of this sort is actually undertaken by most commercial nonprofits. Indeed, if a nonprofit firm is actually providing substantial amounts of service to the poor, or clear public goods such as scientific research, it is frequently able to raise donative income to help cover the cost, and thus is no longer within the category of strictly commercial nonprofits. Second, to the extent that a nonprofit is taking earnings from one portion of its business and using them to cover costs for other services, it will generally not have net income that would be subject to tax even if exemption were withdrawn. And third, cross-subsidization is somewhat like using profits from unrelated businesses to subsidize exempt functions, and many of the same arguments offered above against exempting unrelated business income from tax apply here as well.

In short, it is not easy to rationalize tax exemption for purely commercial nonprofits, and it is worth considering whether more rigorous criteria for exempting such organizations should be devised.

This conclusion is reinforced if we consider the historical path by which commercial nonprofits evolved in various industries. A review of the historical record suggests that nonprofit organizations, generally assisted by substantial philanthropic funding, have played an important role in the beginning stage of the evolution of many service industries -- a stage at which, owing to various problems of market failure, for-profit firms were not viable. Then, as those industries matured, technology, financing, and the information available to both producers and consumers developed to the point where for-profit firms could operate successfully, and could in fact perform adequately most or all of the functions previously performed by nonprofit firms. Nevertheless, nonprofit firms, and especially those that were already well established, continued to prosper and to maintain a substantial share of the market. Thus we observe mature service industries that are heavily populated by nonprofit firms, but in which the nonprofits seem to play no special role.

This scenario seems to describe the nonprofit insurance firms from which congress withdrew exemption in 1986. Arguably it also describes the hospital industry today, and may also describe most other industries in which commercial nonprofits play a substantial role, including nursing care, day care, health maintenance organizations, and fitness centers. Of course, in each of these latter industries there remain some nonprofit organizations that clearly render substantial uncompensated services to the public at large or to the poor and that arguably deserve tax exemption on that ground. University-affiliated teaching and research hospitals, for example, may be an exception to the general pattern among hospitals today. Such organizations are, however, usually the recipients of substantial public or private grant income and thus fall under the heading of donative rather than commercial nonprofits.

If Congress wishes to be more discriminating awarding tax exemption to nonprofit organizations in the future, one possible approach is simply to put more content into the concept of "charity" as it is used in Section 501(c)(3). In particular, it might be appropriate to deny tax exemption to nonprofit firms in service industries in which for-profit firms also have a substantial market share unless the nonprofit firms can demonstrate that they provide a significant quantity of charitable services in the traditional sense of that term -- namely, free or below-cost services for the poor or uncompensated services that are clearly of broad benefit to the public at large. Nonprofit firms with no meaningful amount of donative income would be presumptively taxable under such an approach; to escape the tax, they would have the burden of showing that they perform a socially important role that is not performed by for-profit firms and that the nonprofits themselves could not perform adequately if subject to the corporate income tax.

Mr. JACOBS. Mr. Shillingburg.

STATEMENT OF J. EDWARD SHILLINGBURG, ESQ., PARTNER, LORD, DAY & LORD, NEW YORK CITY

Mr. SHILLINGBURG. Thank you very much. I appreciate your invitation to be here.

I like the relatedness test, I suppose mostly because I've lived with it for a number of years. To move to a test of unfair competition would require me to go down the hall to my antitrust partners and ask them what that means. And I'm not exactly sure what they would tell me, except that I'm sure it would take them awhile to tell me.

Unfair competition is a standard that has existed in other areas, and certainly in the business sector it has produced enormous controversy. Questions go on, such as the scope of the market and what is the relevant market, and vertical integration in the market, and so on.

I recoil not so much from moving to something new. I like new things, but because it doesn't seem to me to be a better standard. I would stay with the relatedness test.

We seem to struggle with changes in the suppliers of things. For example, profitmaking hospitals that was just referenced to; profitmaking day care centers, profitmaking fitness centers. There used to be for-profitmaking business schools. I rather think they are anachronistic today.

There are probably some other examples of organizations that moved to the nonprofit side. We seem to be highlighting transfers to the profit side at the moment.

I don't have clear answers to that. I can tell you anecdotally about working with a child care agency in my area that charges tuition and also has large fund raisings, and I must say that they feel threatened by some of the publicly owned companies that provide child care services, and that lurk in wings ready to come in and, if you will, take over the market that we had developed.

This group that I'm thinking of has been around for 30 years, was formed by community leaders and for a number of years operated without any tuition. Responding to the pressures of providing services, it began to charge tuition, and probably today receives, let's say, 60 percent of its income from tuition. Now, I think it's still exempt, and actually Congress recently has taken steps to assure the exemption of this kind of entity. I think that it should continue to be exempt from UBIT on its tuition withstanding the discovery by some publicly held companies that they can operate for-profit day care centers. If this is not so, then we should look at law and medical schools and other professional schools presently operated on a nonprofit basis, but which return a surplus to the university and apply the UBIT to them.

I agree with the professor that I think one of the issues that goes on here is that when we say something is related, we are saying that the activity is closely related to a function that is important to the community.

Now, I think, as some of the other panelists said, that this committee can deal with specific subjects; advertising income back in the late sixties is an example of that. I'm not exactly agreeable to how that came out, but let's pass that for the moment.

As I read the Treasury report, for example, I think they read some of the losses that they have had in the courts on the hospital side, with more concern than I do. So I would say at this point that, yes, you need information, and there's been talk about how to do that.

If the IRS study is too small, then one of the other alternatives that's been suggested is that the form 990 be expanded. And that means really all form 990 filers, or really all form 990 filers who have gross receipts of more than $25,000, will be responding. A third possibility is for the subcommittee to conduct a more selective study, just as Congressman Patman's committee conducted a very extensive survey of private foundations in the 1960's.

I would also provide incentives and resources to the IRS. I think the IRS has been understaffed. For example, in the college bookstore area, I don't believe there is a published ruling. There are some technical memorandum that are available to practitioners but I'm not sure that there's good publicity, for example, on what the IRS thinks about bookstores.

However, there are published rulings on tours and on health clubs. I think that in many of the areas on which you have received complaints the organizations complained about are paying tax or they're not making a profit.

Mr. Jacobs. That's a good word at this point.

[The statement of Mr. Shillingburg follows:]

STATEMENT OF

J. EDWARD SHILLINGBURG

HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS & MEANS
U. S. HOUSE OF REPRESENTATIVES

June 30, 1987

Mr. Chairman and Distinguished Members of the Subcommittee:

I am J. Edward Shillingburg, a member of the New York City law firm of Lord, Day & Lord where I specialize in tax matters, principally matters involving qualified plans and exempt organizations. Before going to Lord, Day & Lord, I was in the Tax Division of the Department of Justice. I have had an extended interest in the unrelated business income tax ("UBIT").1/ I appear here to express my own views and opinions and not those of my firm or of any client.

I was invited by your Staff to discuss advertising income and UBIT issues affecting qualified plans. I will focus on those two issues, and then offer some general comments.

A. Advertising Income

With a Supreme Court decision issued in April 1986,2/ this subject has entered a phase in which the IRS seems to have the upper hand. Let me give you a sketch of the issues and then comment on the current situation.

Responding to complaints from the taxable magazine industry that certain exempt organizations were publishing substantial magazines with general consumer advertising, the IRS in 1967 proposed regulations which declared that advertising was a taxable unrelated business even though it was carried on within the context of an exempt educational or trade association magazine. The proposals created considerable discussion, but they were issued in late 1967, effective for 1968. The final regulations declared that general consumer advertising was subject to UBIT and, in addition, through examples took the position that specialized advertising dealing with products and services relating to the professional interest of a particular readership was also subject to the tax. The regulations also usefully devoted considerable attention to the computation of the tax.

The controversy over the regulations spilled over into the Tax Reform Act of 1969. Congress enacted § 513(c) which is remarkable for its caption, referring to "Advertising, Etc., Activities," but which does not thereafter refer to advertising. Section 513(c) carried into the Code the basic concept of the regulations that an activity can be "fractionalized" into its components to determine whether any of the components is subject to UBIT. The legislative history made it clear that Congress thought that with this concept substantial advertising income was made taxable.

The 1969 legislation has achieved two results: (1) The exempt organizations publishing general interest publications, such as the National Geographic, the Smithsonian Magazine and Nation's Business, had no alternative but to pay tax. (2) The professional groups which published specialized publications for their memberships and which carried advertising focused on the professional interests of their members were successful in having the 1967 regulations declared invalid as not authorized by the pre-1969 Act legislation. However, in the recent American College of Physicians case, the Supreme Court sustained the current regulations and, although it rejected the IRS's argument that the regulations created a per se test of taxability for professional interest advertising, it agreed with the trial judge's findings that The Annals of Internal Medicine advertising did not contribute substantially to the publications' educational purposes and concluded that it was subject to UBIT. While leaving the door open to considering whether other advertising would be "related," and thus exempt from UBIT, the Court has clearly rejected the formula on which the professional organization publications hoped to win.3/

I am not disappointed with the results for general consumer advertising. The period since the 1969 Act has shown that there continues to be a place in the market for the publications of exempt organizations. They might have been stronger had they not been subject to the tax, but they have certainly not disappeared as a result of the tax. This result may in part be due to the way that the tax is computed. The tax is attracted only if the organization's publication has a profit as a whole, that is, that its net advertising income (gross advertising income less direct and indirect associated expenses) exceeds its net circulation loss (direct and indirect expenses associated with the editorial and other non-advertising content less circulation income). This position was taken in order to place the tax exempt organization's publication on an even basis with the taxable organization's publication, which would, of course, be permitted to offset its income with all of its expenses. The result is that an exempt organization which is interested only in providing a publication can expand the publication to always stay a little ahead of its advertising profits and still pay no tax -- which is the case for the taxable organization, except for its need to provide a return on its invested capital. On the other hand, a real drawback to the development of an exempt organization's publication is that the individuals involved will never realize an entrepreneur's reward for developing a successful publication -- a share in the sales proceeds of the publication or of its stock when it goes public -- because the publication belongs to the organization and it is barred from distributing anything to the developers beyond reasonable compensation.

However, this computational rule effectively bars an exempt organization from using publication profits on a pre-tax basis to fund other activities of the organization.

On the other hand, the outcome for professional interest advertising has been, for me, a disappointment. The advertising in The Annals of Internal Medicine, a highly regarded monthly medical journal containing scholarly articles relevant to the practice of internal medicine, persuaded several judges that it substantially furthered the exempt purpose of its publisher, the American College of Physicians, a § 501(c)(3) organization, but ultimately not enough. I found the discussion in the decisions much more understandable when I looked through some issues of the publication. Attached to this Statement are two ads, one an apparently general interest ad for an established product while the other bristles with technical details, articles and material from the FDA-mandated warnings of effects and side effects. I found the latter ad to be one which I thought substantially furthered the continuing education of the members of the organization.

But there is yet another point of view, one advanced by Chief Justice Burger, to which I want to call the Committee's attention. The Chief Justice concurred in the conclusion of the majority in the American College case because he felt that it followed from a permissible reading of the regulations. However, he called for a liberalized regulation, noting:4/

> There is a public value in the widest possible circulation of [medical developments], and advertising surely tends to reduce the cost of publication and hence the cost to each subscriber, thereby enhancing the prospect of wider circulation. Plainly a regulation recognizing these realities would be appropriate.

But for the adoption of a liberalized regulation, I think that special interest advertising is substantially subject to UBIT. And I find it remarkably inconsistent that a professional organization such as the College of Physicians can rent out exhibit space to drug manufacturers at its annual convention free of UBIT,5/ but it cannot rent out space in its publication to the same manufacturers without paying UBIT.

The advertising area would benefit from increased IRS attention in providing guidelines on allocable expenses.

B. Qualified Trusts, Benefit Plans and Other Organizations

From the statements of the Chairman outlining the scope of these hearings it is reasonable to conclude that the principal focus is on the business activities of exempt organizations and whether such activities are "related" to their exempt purposea. However, the Committee should be aware that the UBIT has a substantial role for a number of organizations.

First, some organizations are barred from having any UBIT. Charitable remainder trusts are ordinarily exempt from tax (and their taxable beneficiaries are taxable on distributions) unless they have UBIT.6/ The result is that such trusts are effectively barred from investing in limited partnerships which conduct an active business.

Second, for some organizations UBIT is based on all income, including passive income, other than income received in connection with the provision of life, sickness, accident, supplemental unemployment compensation, group legal services, and other employee benefits.7/

Third, some organizations are wholly exempt from UBIT, such as State and local government agencies other than colleges and universities. However, some agencies, such as a municipal hospital, library or museum, probably could qualify as a § 501(c)(3) organization if it chose to do so.8/

Finally, pension trusts are subject to UBIT without the exception for "related" business income. Although the UBIT was adopted in 1950 to deal with problems perceived with educational organizations, it was not extended to qualified trusts until 1954. The extension was made to place qualified trusts "engaging in [business] on the same tax basis as business competitors."9/ A qualified trust is a trust which implements a pension, profit sharing, or stock bonus plan qualified under § 401(a). Individual retirement accounts are also exempt from tax except for UBIT.10/

While a charitable organization is subject to tax only on any trade or business which is not "substantially related" to its exempt purposes (§ 513(a)), a qualified trust is subject to UBIT on "any trade or business regularly carried on by such trust or by a partnership of which it is a member" (§ 513(b)). Thus, qualified trusts do not have questions of "relatedness." And, while they have advanced such an argument to claim the exemption for debt financed income purposes, courts have interpreted § 514(c)(4) as not providing qualified trusts with an exemption under that provision either. However, the IRS has ruled that the dividends and other income from employer stock held by a leveraged employee stock ownership trust is exempt from the debt financed income rules because the acquisition and holding of such stock are integral to its exempt purpose.11/

Several issues could be addressed for qualified trusts:

(a) Why are qualified trusts taxed for UBIT purposes at trust rates? Perhaps the better question is -- why are charitable trusts taxed at trust rates, and charitable corporations at corporate rates? When the UBIT was adopted in 1950 the concept was probably that the tax rate went along with the choice of organization -- and there were then a number of charitable trusts. However, today we organize ten charitable corporations for every charitable trust -- and the decision is made on the basis of ease of administration and limited liability afforded by the detailed corporation laws of the States, particularly if the group setting up the organization consists of persons other than one or two family members.

But for qualified trusts, there has never been a choice of organizational form; plan sponsors have only a choice between a trust and a custodial account which is deemed to be a trust, and a group annuity contract issued by an insurance company which, at least until recently, was insulated from UBIT.12/ Of course, plan sponsors take all forms -- C corporations, S corporations, partnerships and sole proprietors. And the competitors of the business activity of both charitable organizations and qualified trusts may take all such forms. But why should the UBIT rate be different for a charitable trust and a charitable corporation? Why shouldn't it be the corporate rate or the trust rate or a composite -- but nevertheless a uniform rate?13/

(b) Partnerships present various issues for the potential investor which is a qualified trust or a charitable organization. But some of them are not real. Since both organizations have traditionally invested in forms of investments which yielded dividends, interest, rent from real property and capital gains -- types of income excluded from UBIT under § 512(b) -- these investors often perceive a partnership investment with associated UBIT as a tax to be avoided. However, since the partnership is not itself a taxable entity and the partner is, the qualified plan or charitable organization investor is appropriately paying UBIT at the partner level on its share of the partnership income from the operation of a business. If it did not, then such operating income would be exempt at both the partnership and partner level, a desirable result, but not one which can be justified.

If they had invested in a corporation which operated a television cable business, the corporation would pay corporate income tax on its income from the cable activity and the qualified plan investor would not incur UBIT on the after-tax distributions of such earnings (dividends) and it would on the sale of its stock realize a price based in part on the value of the undistributed profits free of a discount for any further tax on them. However, if it invested in a partnership cable company, the partnership incurs no tax; the partner qualified trust incurs UBIT on its share of operating profits, whether or not distributed, and on the sale of its partnership interest it realizes a price in part representing a premium for the fact that the partnership has retained profits on which the tax has been paid, and the qualified trust incurs no UBIT on the sale (aside from certain receivables and recapture items). Thus, in both instances there is a single tax on the cable profits, either at the corporate level or at the partner level, but in neither case a double tax. Of course, if the cable partnership also has dividends, interest and other types of income which are excluded from UBIT, that income will retain that character and a qualified trust or exempt organization will not be subject to UBIT on their share of such dividend, etc. income.

Partnerships should be required to advise partners subject to UBIT on their Schedules K-1 of their allocable share of income subject to UBIT, if any, and qualified trusts and charitable organizations should be able to rely on such Schedules in reporting such income.

(c) I find it hard to explain debt financed income to managers of qualified trusts. Of course, if they invest in a partnership conducting an active business, the share of such income which is allocated to a qualified trust is subject to UBIT even if the partnership is leveraged. However, if the partnership is investing in, say, securities which are debt financed, the income will be subject to UBIT under the debt financed income provisions. Only pooled real estate investments have an exception in § 514(c)(9). However, if a pension trust invests in a corporation, none of the qualified trust's dividends from the corporation will be subject to UBIT even if the corporation is significantly leveraged. I suggest that § 514(c)(9) could be extended to other forms of investment since the concerns which gave rise to § 514 -- the Clay Brown transactions -- have been mitigated by the deemed interest and original issue discount rules and the elimination of the reduced tax rate for capital gains.

(d) We are in a period of rapid development of financial products and forms of business organization. For example, the 1986 tax legislation has made partnerships the preferred form of business organization because corporate tax rates will exceed individual tax rates. It also introduced real estate mortgage conduits ("REMICS"), including a provision that an exempt organization holding a residual interest will be subject to UBIT on its "excess inclusion," expanding the debt financed income exception in § 514(c)(9) and added a new exempt title holding company.14/ In the past few years we have seen traded options become established and futures transactions are now offered on a broad variety of financial instruments, indices and commodities. We all look back with grief at the delays in working out the UBIT consequences of securities lending -- delays which finally required legislation.15/ The IRS must be provided with resources to respond to such financial product developments and legislation promptly so that pension trusts may effectively use them.

(e) A plan sponsor does have the alternative of investing in a group annuity contract which may be written against a special account of an insurance company. While income on the special account is not taxed to the insurance company, it has been regarded until recently as not generating UBIT for the qualified trust. Section 514(g), as added in 1984, authorized the Treasury to issue regulations "to prevent the circumvention of any provision of [§ 514] through the use of segregated asset accounts." No regulations have been proposed to date.

C. General

(a) I am not convinced that the present UBIT structure should be eliminated. It has developed in response to very substantial pressures. On many of the issues which critics feel are "vague" or "gray", the IRS has devoted considerable attention and produced guidelines which are discoverable and capable of application. The result is complex. And I too have spent a few hours considering whether 1,000 items in a museum shop are "related," "unrelated," or "convenience" items. But I think that exempt organizations should be able to conduct business activities free of tax if they materially assist their exempt purposes (aside from the production of income).

(b) The IRS has devoted considerable resources to the UBIT area in the form of Publication 598, Tax on Unrelated - Business Income of Exempt Organizations (Rev. May 85), and in preparing and making available to its personnel and to the interested public issues of its Exempt Organizations Continuing Professional Education Technical Instruction Program (Tng. 4277-20). I urge that more resources be devoted to this area.

1/ Shillingburg, "Using Merchandise Sales to Advance Charitable Purposes," 14 *N.Y.U. Conference on Charitable Organizations* 13-1 (1985); Shillingburg, "*American College of Physicians* v. *United States*: An Ending -- A Beginning -- Or", 64 Taxes 539 (1986).

2/ *United States* v. *American College of Physicians*, __ U.S. __, 86-1 USTC ¶9339 (1986).

3/ For subsequent cases, see *Florida Trucking Assn.* v. *Commission*, 87 TC No. 66 (1986); *Fraternal Order of Police, etc.* v. *Commissioner*, 87 TC No. 45 (1986); *American Hospital Assn.* v. *United States*, 87-1 USTC ¶9291 (N.D. Ill. 1987).

4/ __ U.S. __, __. 86-1 USTC ¶9339 at p. 83,714.

5/ Code § 514(d)(3).

6/ Code § 664(c).

7/ Code § 501(c)(7) (social clubs), (9) (VEBAs), (17) (supplemental unemployment compensation plans), (20) (black lung trusts).

8/ Code §§ 115, 511(a)(2)(B). Rev. Rul. 60-384, 1960-2 C.B. 172; Rev. Rul. 74-15, 1974-1 C.B. 126; Code § 508(a).

9/ H. Rep. No. 1337, 83d Cong., 2d Sess. (1954) (1954 U.S. Code Cong. & Ad. News 4017, 4071).

10/ Code § 408(e)E.

11/ Compare *Ocean Grove Corp. Retirement Plan* v. *United States*, 8 EBC 1498 (S.D. Fla. Feb. 19, 1987), with Rev. Rul. 79-122, 1979-1 CB 204.

12/ Code §§ 401(a) and (f); Code § 403(a).

13/ Until recently trust rates were greater than corporate rates; under the 1986 Act the top corporate rates will exceed the top trust rates for the first time in many years.

14/ Code §§ 860E(b), 501(c)(25).

15/ Code § 512(a)(5) and related provisions.

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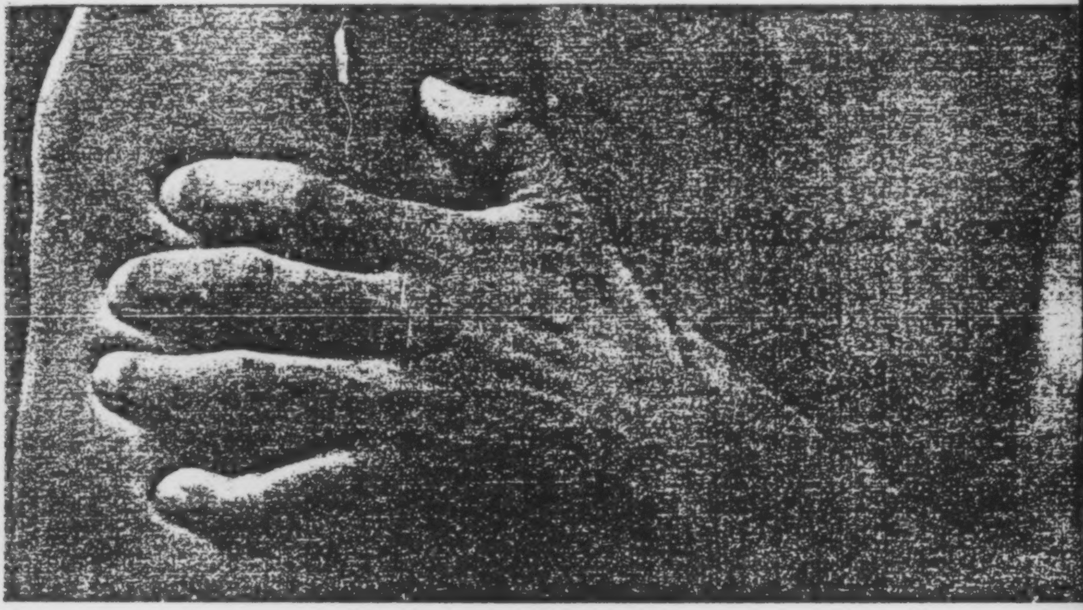

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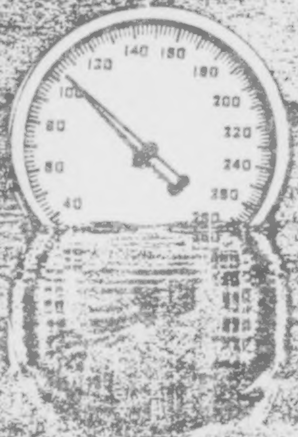

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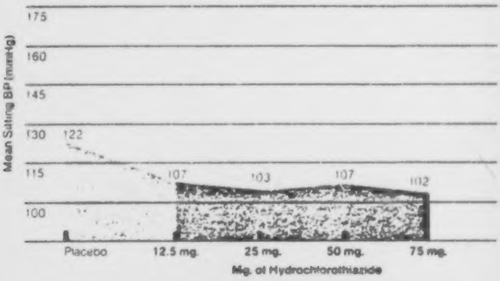

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1 Kaplan N. Systemic Hypertension: Therapy in Braunwald E (ed.): Heart Disease: A Textbook of Cardiovascular Medicine. Philadelphia, W.B. Saunders Co., 1980, vol. 1, pp 922-951

2 Dialogues in Hypertension: Hypertension Update II: New Developments in Antihypertensive Therapy, Jan. 1985. Health Learning Systems Inc.

3 Adapted from Beerman B. and Groschinsky-Grind M.: Antihypertensive Effect of Various Doses of Hydrochlorothiazide and its Relation to the Plasma Level of the Drug. Eur J Clin Pharmacol 13:195-201, 1978

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Diuretics reduce renal clearance of lithium and increase the risk of lithium toxicity.

Adverse Reactions: Muscle cramps, weakness, dizziness, headache, dry mouth; anaphylaxis, rash, urticaria, photosensitivity, purpura, other dermatological conditions; nausea and vomiting, diarrhea, constipation, other gastrointestinal disturbances; postural hypotension (may be aggravated by alcohol, barbiturates, or narcotics). Necrotizing vasculitis, paresthesias, icterus, pancreatitis, xanthopsia and respiratory distress including pneumonitis and pulmonary edema, transient blurred vision, sialadenitis, and vertigo have occurred with thiazides alone. Triamterene has been found in renal stones in association with other usual calculus components. Rare incidents of acute interstitial nephritis have been reported. Impotence has been reported in a few patients on 'Dyazide', although a causal relationship has not been established.

Supplied: 'Dyazide' is supplied as a red and white capsule, in bottles of 1000 capsules; Single Unit Packages (unit-dose) of 100 (intended for institutional use only); in Patient-Pak™ unit-of-use bottles of 100.

BRS-DZ L41

The unique red and white

Mr. **Jacobs**. Mr. Dale.

STATEMENT OF HARVEY P. DALE, PROFESSOR OF LAW AND DIRECTOR, STUDY ON LAW AND PHILANTHROPY, NEW YORK UNIVERSITY SCHOOL OF LAW

Mr. **Dale**. Thank you. It's pleasure to be here.

My name is Harvey Dale. I'm a professor of law at the New York University School of Law. I'm the director of that law school's study on law and philanthropy, and for 15 years I've taught on the graduate tax faculty there.

As a member of the NYU faculty, I have long been aware of, and have been quite grateful for, the profits that a tax-exempt organization may sometimes earn from the operation of an unrelated business of selling macaroni.

I would like to make comments in two parts today, primarily to shed confusion, I think, as law professors will. I have some criticisms and some comments on the Treasury proposals, but I understand that should be reserved till later.

First, about the relatedness test. I did some historical research on that and found, as the Treasury did, that it dates back to some 1942 suggestions of the Treasury put forth by Randolph Paul, the Tax Adviser to the Secretary of the Treasury.

In 1942, he testified about the problems of tax-exempt entities competing with businesses, and identified two concerns, loss of revenue potential and unfair competition. He continued directly from those diagnoses to the following prescription: "It is therefore suggested that such corporations be taxed on income derived from a trade or business not necessarily incident to their exempt activities."

What is astonishing is that there is no explanation of how he got from the diagnosis to the prescription, and there has not been since. If unrelatedness works, it is certainly not because it has had, at any time up to the current date, a principled exposition of where it came from.

Let me see if I can be more clear. If you were concerned about competition, presumably you would, if you were addressing the question directly, draw a line between activities which are competitive and activities which are not competitive, and you would expect some kind of words that connoted competition in the test. With only the exception of last year's imposition of tax on TIAA-CREF and Blue Cross/Blue Shield, that has not been our model.

On the other hand, if you were concerned, as the Treasury was and continues to be, that passive activities were good and active businesses were bad, presumably you would try to draw a line based on activity or passivity of the generation of the income. That, too, we have not done except incidently.

What we have done from the beginning is talk about relatedness, but it's an unexamined premise. Now, there are two things that could flow from that. One is we could say let's throw it out, we don't understand it. I suggest exactly the opposite. I suggest that the relatedness test is indeed, at least today, a confession of ignorance, but also perhaps the course of wisdom.

We talk about relatedness because we believe that we understand at least some of the things that tax-exempt organizations traditionally have done. And we find them doing what they have long been doing. And in 1942 and in 1950 we say, "Well, we understand that." What we're worried about is the growing out of proportion. And the way to say what we will permit is to say, we will permit them to do pretty much what they have been doing. And relatedness, therefore, relies on history instead of logic. I think that reliance on history instead of logic may be the course of wisdom.

Indeed, one of our great lawyers, Oliver Wendell Holmes, said that on page 1 of The Common Law, "The life of the law has been history, not logic."

But it is important to say the relatedness is not an examined notion, and the Treasury says the same in its testimony. So I shed confusion.

My second shedding of confusion I hope will be on the scope of the UBIT. And here I simply want to suggest that life is very complicated. It frustrates me that that's so, teaching the Internal Revenue Code. The Internal Revenue Code is not a book for the gentle reader, and it's getting worse all the time.

The notion that the unrelated business income tax is designed to level the playing field derives from a mental image. The image is that the tax law exempts not-for-profit organizations from tax. It imposes tax on for-profit organizations, and that amounts to a subsidy in favor of the not-for-profits so that we have a simple surface, a plain surface, like a playing card, tilted towards the not-for-profits. I think the simple image is misleading and wrong. The actual situation, unfortunately, is much more complex.

In my written testimony, I give a series of examples, but let me just try to hit you with three that could be quite significant.

From 1981 through 1986, the combination of investment tax credit and accelerated cost recovery system depreciation amounted to a negative tax. That is to say, it was literally a refund to taxable organizations that bought eligible tangible equipment. It provided them literally with net capital to be used for other purposes in their businesses. That tax subsidy, which was conscious and intended, was not available to not-for-profits. It may account in part for the rapid growth of for-profit hospitals during that period of time. I emphasize "in part."

Again we provide that ownership of property provides tax benefits to the owners by way of depreciation, interest, and other benefits. We allow owners of such property to lease the property to capital-poor for-profit businesses thereby passing on that tax benefit. That's the very purpose of a lease.

We permit that, however, not at all to tax-exempt entities. The result of that is a comparative cost disadvantage to not-for-profit organizations which cannot, through leasing, achieve the benefits which all the for-profit community can.

The same thing may be true about net operating losses because, while net operating losses are in theory available to nonprofits in the code for start-up operations, the administrative position of the Service by and large denies that. So that in cases in which a for-profit business starts up and loses money, it can automatically set off those losses against future profits. But, by and large, administratively the Service will not permit that for not-for-profit organizations.

I don't mean to suggest that it tilts the other way. I only mean to suggest that, sadly, life is more complicated. The surface is not a plane tilted towards the not-for-profits. It's rather bumpy and gnarled, and it would be hard to tell, in any particular case where a marble would roll if dropped on the top of that surface.

[The statement of Mr. Dale follows:]

TESTIMONY
of
HARVEY P. DALE

Professor of Law
and
Director, Study on Law and Philanthropy
New York University School of Law

My name is Harvey P. Dale. I am a Professor of Law at the New York University School of Law, and the Director of that Law School's Study on Law and Philanthropy. I have recently been appointed a member of the new Advisory Group to the Commissioner of Internal Revenue on Exempt Organizations. I am also a member of the Committee on Non-Profit Organizations of the Association of the Bar of the City of New York, whose testimony was presented earlier in these hearings.

As a member of the N.Y.U. Law School faculty, I have long been aware of, and quite grateful for, the profits that a tax-exempt organization may sometimes earn from the operation of the unrelated business of selling macaroni.[1]

My comments today are in three parts: first, a discussion of the history of the "relatedness" notion in the Internal Revenue Code's UBIT provisions; second, some observations about the impact of the Federal income tax on non-profit and for-profit organizations; and third, a few recommendations for action by this subcommittee and the Congress.

"RELATEDNESS"

From the earliest days of this century -- even prior to the adoption of a general income tax in 1913 -- our taxing provisions provided an exemption for certain entities "organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual."[2] The Supreme Court, in Trinidad v. Sagrada Orden de Predicadores,[3] interpreted virtually identical language[4] as affording tax exemption to a religious organization, even though it earned just less than three percent of its income from the sale, to its own members, of chocolate, wine, and other articles.

The opinion is interesting for two reasons. First, it is often cited as the genesis of the so-called "destination" test for tax exemption. That test held that an organization could qualify for tax exemption so long as the ultimate destination, or use, of its income was for the prescribed religious, charitable, etc., purposes, regardless of the source of the income. The relevant language in the opinion, however, is mere dictum.[5] Second, it may be that the "relatedness" notion stems from an ambiguity in the Court's discussion of the sale transactions:

> "The articles are merely bought and supplied for use within the plaintiff's own organization and agencies -- some of them for strictly religious use, and the others for uses which are purely incidental to the work which the plaintiff is carrying on."[6]

It is not clear from the context which of two possible meanings to put on the emphasized words. Do they mean that the sales were incidental in the sense of being trivial or unimportant? Or do they mean that the sales were incidental in the sense of being related to the exempt activities of the taxpayer?[7] Either interpretation would be correct on the facts of the case; neither seems compelled.[8]

In 1942, the "relatedness" concept emerged in the legislative process for the first time. Randolph Paul, then Tax Adviser to the Secretary of the Treasury, testified about the problem of tax-exempt entities engaging in businesses. He identified two concerns: loss of revenue, and unfair competition with for-profit enterprises. He continued: "It is therefore suggested that such corporations be taxed on income derived from a trade or business not necessarily incident to their exempt activities."[9] It is clear that Mr. Paul was using the emphasized phrase in the second sense, i.e., as connoting relatedness, not triviality.[10] It is interesting, however, that the perceived abuses -- loss of revenue and unfair competition -- would have been more cleanly addressed by taxing all income from competitive businesses, whether such businesses were related or unrelated to the exempt activities of the organization. The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed.[11]

Although the 1942 Hearings did not directly result in taxation of such income, they formed the basis for the Treasury's 1950 recommendation of a similar tax. Secretary John W. Snyder and Tax Legislative Counsel Vance Kirby both suggested a tax on "unrelated" business activities of exempt organizations.[12] The testimony is interesting both for what it condones and what it condemns. Passive income received by exempt entities is clearly approved for tax-free status; the only reason enunciated is that such receipts are "the traditional sources of income of these institutions . . . ."[13] Active business income is clearly targeted for taxation, but only if unrelated to the institution's exempt activities.[14] The resulting legislation adopted the relatedness test, which continues in the Code to the present date.[15]

Curiously, the chosen line is, in part, unexplained. If the evil is competition, one might expect a line to be drawn based upon the existence or absence of competition. If the evil is the conduct of an active business, one might expect a line to be drawn based upon active-versus-passive income. Instead, the distinction depends upon neither, but rather upon relatedness. I submit that this is a confession of both ignorance and wisdom. It is ignorant, because we simply have no completely-acceptable rationale which would explain why particular exempt organizations may avoid income taxation while they actively compete with for-profit entities -- yet it is clear that they may, so long as the business in question is "related" to their exempt activities. It is wise, because, in the absence of widely-agreed theories, and lacking (as we do) comprehensive data about the impact of competition, the relatedness notion accepts the system as it exists, and allows it, in general, to go forward without undue change but without permitting aggravated abuses.

Yet there may be abuses. Prior testimony, news stories, and other writings suggest that some do exist. They should be corrected and prevented. The only question is: how? Before making a few comments on that question, let me turn to a brief analysis of a few aspects of the income tax pattern affecting non-profit and for-profit businesses.

FOR-PROFIT AND NON-PROFIT BUSINESSES

A simple image is suggested by complaints about unfair competition between for-profit and nonprofit entities: taxes are a cost of doing business; avoiding taxes may be viewed as a subsidy; tax exemption thus presents a tilted playing field, in which subsidy-like benefits flow to the nonprofit community to the detriment of for-profit enterprises.

The simple image is misleading and wrong. The actual situation is, sadly, significantly more complex. As is often and frustratingly the case with the Internal Revenue Code, an accurate picture cannot be painted without devoting tedious attention to a myriad of apparent details -- but details which may become overwhelming in cumulative effect.

For example, there are situations in which for-profit entities pay a lesser tax than nonprofits. For the years 1981 through 1986, the combination of the investment tax credit and the accelerated cost recovery system often produced a negative tax rate for the purchase of qualifying equipment. Those benefits, unavailable to exempt organizations, amounted to a conscious subsidy to for-profits. The tax system actually provided capital for their use. The benefit was directly proportionate to the amount of eligible tangible personal property acquired, which may account, in part, for the rapid growth of for-profit hospitals during those years. Even now, the tax benefits of ownership of equipment -- including deductions for depreciation, interest, and other costs -- may be transferred to capital-poor for-profit enterprises through lease transactions. This, in general, should reduce the cost of such property to those businesses. Non-profit organizations are forbidden to obtain these benefits, which should comparatively increase their costs for such property.[16] Furthermore, start-up losses, which are readily available to for-profit enterprises to set off against later profits, are often administratively denied to nonprofit enterprises.[17]

Although these could be multiplied, it is not my purpose to produce a catalog of such examples. Nor would I argue that such examples, separately or together, suggest that for-profit enterprise is always unfairly tax favored over nonprofits. It may be, however, that in particular situations such a result may occur. Of course, the opposite is often true, i.e., that for-profit businesses pay a higher tax than nonprofits. What is not clear, at least to me, is how properly to describe the resulting pattern. It seems clear that a simple image of an inclined plane surface is woefully inadequate and deceptive. Instead, the surface seems bumpy and uneven, so that a marble placed at random on it might roll either toward or away from the nonprofit edge.[18]

On the other hand, the current UBIT does not always work to level out bumps or realign a tilted taxing surface. Consider, for example, a for-profit enterprise which produces items pursuant to its own patent.[19] The net profits, of course, are subject to income taxation. If a nonprofit organization conducts the same activities as an "unrelated" business, the same or a similar income tax liability will result. If, however, the nonprofit, rather than conducting the business, purchases the patent and licenses it, the resulting royalties will entirely escape tax.[20] They will not be taxed to the nonprofit entity, because they are explicitly excepted from the scope of the UBIT.[21] They will not be taxed to licensee, because royalties are deductible against the licensee's tax base.[22] A similar point could be made about any of the various types of income which, while exempt from UBIT in the hands of a nonprofit entity, are deductible from the tax base of a for-profit payor.

Two final comments may be made about the UBIT. First, the presence or absence of the UBIT does not explain even all of the anecdotes of "unfair" competition presented to this committee. For example, I understand that one hearing-aid retailer complained that a local nonprofit hospital took away much of his business by selling hearing aids to the community in which he had long been established. Not only did the hospital take away business, it did so by selling (allegedly) inferior merchandise and at higher prices! Whatever this anecdote illustrates, even if we take it at face value, it does not illustrate a situation which the UBIT could efficiently address. There is no way in which a simple tax "subsidy" could account for the success of the nonprofit. The story is about marketing, not pricing.

Second, in considering what sort of competition may be viewed as "unfair," some thought must be given to the interest of the consumers. Normally, our capitalist system does not protect competitors from one another. Their economic losses from competition are thought to be acceptable, viewed from the standpoint of a society of users of their services and goods.[23] I do not urge that the interests of consumers should justify any and all tax "subsidy" to nonprofits. I do urge, however, that thought be given to the question of how properly to weigh such interests in analyzing pricing, and other aspects of economic behavior, of nonprofits, as affected by the UBIT.

RECOMMENDATIONS

I urge caution and humility in addressing the problems which have been discussed in these hearings. The charitable sector of this nation includes many frail entities. The impact of legislation can be very great, because its effects are both direct -- in the Internal Revenue Code itself -- and indirect -- through other regulatory schemes which borrow, often uncritically, from the Code's definitions. Furthermore, we do not know enough about what we are doing. The "relatedness" notion in the UBIT does not respond perfectly to the concerns which motivated its inventors. The current taxing pattern is strangely complex, presenting a surface which is gnarled rather than simply tilted. Thus, the problem is: even if the system is broken, our current understandings are so impoverished that we must doubt the accuracy of any diagnosis, much less the beneficial effect of any prescribed cure. To quote H.L. Mencken: "For every complex problem, there is a solution which is simple, elegant, . . . and wrong." For the present, we should follow the ancient oath of Hippocrates, and at least abstain from doing harm.

Our society is vastly complex. The roles of government, private industry, and the nonprofit sector are deeply intertwined. Indeed, that is one of the essential, and cherished, aspects of this United States, remarked upon with admiration by observers ever since de Tocqueville. Tax legislation may easily change the balance and dynamic of the system, but in our current ignorance we cannot be sure of just how. Our forefathers embraced the common law to regulate this country. It has often been remarked that the genius of the common law is its case-by-case approach, never deciding more than is required to deal with the situation at hand, allowing the overall pattern to build up by accretion, like a coral reef. We are now largely no longer a common-law society, but rather one of codes. Yet the care and caution of the common-law approach may still be valid, even for legislation.

Today, we are faced with four factors which, taken together, argue for restraint. First, the history of our nation is reflected in the current intertwining among the three sectors. As Justice Holmes remarked, "The life of the law has not been logic: it has been experience."[24] Second, we do not have any careful and comprehensive rationale for the scope and operation of the tax exemption. We do not have any satisfactory theory, legal or economic, to apply in making judgments about it. Third, although we have heard many anecdotes, we lack sufficient data to form a balanced picture of the true scope or impact of competition between for-profit and non-profit organizations. Fourth, and perhaps most important, we have reason to believe that much more useful data will be forthcoming in the next few months and years. Current signals include the TCMP study and the formation of a new Exempt Organization Advisory Group by the Service, the growth of better statistics on and a new taxonomy of the independent sector, and a recent explosion of academic and other studies. This committee can assist by proceeding with caution, and by supporting or mandating further studies of the issues. It is precisely because better information and improved understandings seem close at hand that wisdom may suggest pausing rather than rushing forward.

With better insights, we will better understand the scope of the problems, and then better responses can be fashioned. But for now, before legislating a general "solution," I join Cromwell in saying, "I beseech you, in the bowels of Christ, think it possible you may be mistaken." Judge Learned Hand quoted that sentence in testimony before the Senate Subcommittee on Labor and Public Welfare on June 28, 1951. He continued:

> "I should like to have that written over the portal of every church, every school and every courthouse. May I say I should even add over the portal of every legislative room in the United States?"[25]

FOOTNOTES

1. See *C.F. Mueller Co. v. Comm'r*, 14 T.C. 922 (1950), *rev'd*, 190 F.2d 120 (3d Cir. 1951). See also the testimony of John Gerdes, Esq., on behalf of New York University, in 5 *Revenue Revisions, 1947-48: Hearings Before the House Committee on Ways and Means*, 80th Cong., 1st Sess. 3525 *et seq*. (1948).

2. Corporate Excise Tax Act of 1909, Section 38, 36 Stat. 112 (1909). I am grateful to the author of the following extremely useful article for this insight, as well as several others in my testimony: Eliasberg, *Charity and Commerce: Section 501(c)(3) -- How Much Unrelated Business Activity?*, 21 TAX L. REV. 53, 55 (1965) (hereinafter cited as "Eliasberg").

3. 263 U.S. 578 (1924).

4. The only differences were (1) the addition of the word "scientific" to the listing of purposes for which tax exemption was available, and (2) the use of "net income" instead of "profit." The relevant statute was the Act of October 3, 1913. *Ibid*.

5. The Court said the Act "says nothing about the source of the income, but makes the destination the ultimate test of exemption." *Ibid*.

6. *Ibid*. (emphasis supplied).

7. Both meanings are proper dictionary understandings of the word, "incidental." Thus, Webster's Third New International Dictionary (G. & C. Merriam 1981) defines "incidental" either as (1) "unimportant" or "nonessential" or "minor," or as (2) "appertaining to" or "associated or naturally related" to. And the 1901 edition of the Oxford English Dictionary defines it either as (1) "accessory or subordinate" but of "no essential part," or as (2) "relating or pertinent." It treats the latter, however, as obsolete.

8. Accord, Eliasberg at 64.

9. 1 *Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means*, 77th Cong., 2d Sess. 89 (1942) (emphasis supplied).

10. Immediately above the language quoted in the text, *supra*, Mr. Paul had referred to exempt corporations which "engage in trades and business *completely unrelated to* their exempt activities." *Ibid*. (emphasis supplied).

11. Not only the relevant legislative history, but also several of Mr. Paul's other writings in the income tax area were examined but contained no illumination.

12. 1 Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 19 (statement of Secretary Snyder); Id. at 165 (testimony of Tax Legislative Counsel Vance Kirby). Mr. Kirby, acknowledging that the genesis of the 1950 proposal was the earlier testimony of Randolph Paul, said, "A similar proposal was presented to the committee in 1942 . . . ." Ibid.

13. Ibid.

14. Mr. Kirby made this explicit, when he testified: "Moreover, only business income which is not incident or related to the exempt purpose would be taxed. For example, a university bookstore may continue to sell textbooks to students, an agricultural college may run a wheat farm in connection with its educational program, a social club may sell food to its members, without affecting its tax exempt status. All of these activities would continue to be exempt from tax. Only the unrelated business would be taxed -- the spark-plug or chinaware factory run by a university." Id. at 166.

15. Internal Revenue Code of 1986, Section 513(a).

16. Internal Revenue Code of 1986, Section 168(h).

17. The law does permit net operating loss carry-forwards to nonprofit organizations operating an unrelated business. Internal Revenue Code of 1986, Section 512(b)(6). The Service, however, typically takes the position that start-up losses of a nonprofit do not become part of a net operating loss, since the activity, at inception, is not carried on for profit. Cf. Treas. Reg. Section 1.512(b)-1(e)(3); Rev. Rul. 81-69, 1981-1 C.B. 351; The Brook, Inc. v. Comm'r, 86-2 U.S.T.C. para. 9646 (2d Cir. 1986), reversing 51 T.C.M. 133 (1985); Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974).

18. A mathematical topologist might describe it, not as a standard embedding of a plane, but as a surface wildly embedded in 3-space.

19. The for-profit may have been able to deduct the cost of research and development attributable to the patent, or may be able to depreciate the patent's cost (if purchased) over its useful life.

20. A different result might follow if the patent had been purchased subject to an indebtedness, and the royalties thus became "unrelated debt-financed income." Internal Revenue Code of 1986, Sections 512(b)(4) and 514.

21. Internal Revenue Code of 1986, Section 512(b)(2).

22. Whether this pattern produces a lower overall tax primarily depends upon the amount of the royalty income as compared to the amount of depreciation of the purchase price of the patent.

23. The Internal Revenue Service sometimes has urged that such competition is good, and to be encouraged, even between for-profit and nonprofit entities, albeit in a different context than the UBIT. E.g., Rev. Rul. 83-175, 1983-2 C.B. 109 (tax status of "deposits" analyzed; competition between tax-exempt credit unions and taxable banks is to be encouraged).

24. O. HOLMES, THE COMMON LAW 1 (Little, Brown, & Co. 1881).

25. *Establishment of a Commission on Ethics in Government: Hearings Before a Subcommittee to Study Senate Concurrent Resolution 21 of the Senate Committee on Labor and Public Welfare*, 82d Cong., 1st Sess. 218 (1951) (Statement of Judge Learned Hand). The same sentiments, in slightly different words but attributed to the same source and occasion, appear as L. HAND, *Morals in Public Life* (1951), reprinted in THE SPIRIT OF LIBERTY 170, at 174 (Vintage Books 1959).

Mr. Jacobs. The staff is interested in comments from the panel on the nine recommendations of the Treasury with regard to the subject.

I think in the interest of time we might try to structure this under the doctrine of qui tucit concentari. If you don't disagree with one of those, then we would accept your silence as an indication of that.

So why don't we just take the one through nine. How say you on the first, yea or nay?

Ms. Rose-Ackerman. I hesitate to be put in the position of voting by silence. [Laughter.]

Mr. Jacobs. I know. Most of us do. But in the case of this situation, let's try it.

Does anybody have any serious objection to recommendation No. 1 as set before you? And let me say, parenthetically, the staff would like to have back each of the copies if you'll be so kind as to leave them with the staff when we've concluded.

Mr. Hasson. Mr. Jacobs, I have no disagreement with the basic recommendation. As one brief point, however, there was a suggestion by some that all exempt organizations be required to file a form 990–T. I don't believe that is adequate.

I believe that, as you suggested in your questions earlier, what is necessary is a modification of the form to identify nondonative revenue generating activities which may or may not be subject to the unrelated business tax.

Mr. Jacobs. Anything further on Item No. 1?

Mr. Dale. I'd like to comment on the information gathering.

I think there are several recommendations that you could pick up here. First, if we can expand reporting, and the committee wants to be able to use the data, you have to be beware of a balancing, and then beware of a trap. The balancing is between voluntary compliance and disclosure.

The current provisions in the code, section 6103, that provide generally for secrecy and confidentiality of tax information and tax return information are designed by the Congress to enhance voluntary reporting. To the extent that you make the reporting public, there is a perception that you may be decreasing voluntary compliance.

However, once you've made that balancing decision, you should be careful to beware of 6103.

Now, there is precedent for that. Some of the returns already filed by tax-exempt organizations are public, and other legislation, bank secrecy legislation, for example, has called for forms to be filed, not with the Service, but with the Treasury for the purpose of avoiding those rules. If the data are to be available, you may want to consider that balancing.

I think if you want to include a major portion of the sector, and I refer here to churches and religious groups, you should expect controversy and you should expect also the possibility of a constitutional challenge. And in drafting the legislation, your staff should do careful research and prepare an appropriate statement of purpose to defend the disclosure requirements against what is an almost certain attack at some juncture.

And my third and last point is that the census is coming, and it's a once in every 10-year opportunity to get information from the entire populace. The access to the form is jealously guarded, for good reason. But if this committee has concerns, this is the time to make them known to the Census Bureau.

Mr. JACOBS. Ms. Rose-Ackerman.

Ms. ROSE-ACKERMAN. Yes, I would like to follow up on some of his comments.

I think there is a question of whether the 990 is the appropriate way to get additional information, or whether something done through the Census Bureau is a more appropriate means of getting broader information, not just on nonprofits but on industry sectors in which they are active.

I think the question of the inclusion of religious organizations is very important. I believe that one point could argue that the current exemption for religious institutions is unconstitutional, that it is unconstitutional for government to favor religious bodies in this way. So while I agree that it's a controversial issue, the Constitution arguments don't all go one way.

Finally, if the committee is contemplating making some recommendations that have to do with the gathering of information, then I would suggest not focusing too narrowly on the UBIT, or you may have lost a very important opportunity for a broader understanding of what's going on.

Mr. JACOBS. Item 2.

Mr. HANSMANN. May I just say a quick word about Item 1?

Mr. JACOBS. Yes, sir.

Mr. HANSMANN. Though, in general, I think I would, if anything, go further than the Treasury in taxing unrelated business income.

This is one case where I might be inclined to go slow. I think that the fact that there is voluntary—first of all, that the service does not recommend much in the way of specific taxation of—they just study here for the most part too. But I think that the fact that there is some substantial amount of volunteer labor contributed to a service is some indication that something is being done by this organization that is not being done or capable of being done by competing for-profit firms, I think is the critical test here. And I think one should consider that substantial evidence that perhaps this is not to be included as unrelated activity.

Having said that, there may be exceptions. And I agree with the Treasury that you want to impute wages if you do this in computing.

Mr. JACOBS. Is everybody going to say everything about everything? We'll be here till midnight. [Laughter.]

Go ahead, Mr. Shillingburg.

Mr. SHILLINGBURG. There is a very significant group that's subject to the UBIT tax which does not have the benefit of the relatedness test, and that's the pension plans.

However, once you get into the computation of the tax, expenses, subsidiaries, partnerships, and so on, those are issues which affect the pension plans, and I ask you to keep that in mind.

Mr. JACOBS. As I say, when we go through the rest of these eight, perhaps we should remember the wisdom of Louis Brumfield, I speak because I have something to say, not because I have to say something. We will not deem you unworthy if you have nothing to say.

Item No. 2.

Mr. HASSON. The Treasury, on the convenience exception, Mr. Jacobs, failed to note that the Internal Revenue Service, in 1974, authored a general counsel memorandum that specifically and directly applied the convenience exception in the university bookstore context and recommended the publication of a revenue ruling.

To the best of my knowledge, that revenue ruling has never been published. It would certainly be possible to codify that type of determination which has already been made.

Ms. ROSE-ACKERMAN. I just want to reiterate my belief that a lot of the concern over related and unrelated business is misplaced. I certainly wouldn't want to see the IRS move toward a tighter definition of unrelated business income when it seems to me that we haven't really shown a major problem with the existing standard.

Mr. JACOBS. Item No. 3.

Mr. DALE. I abstained on 2, although law professors, generally speaking, are generally speaking. But on item 3, I do have a comment on the allocation of expenses.

The Treasury suggests an allocation which is quite different here than for for-profit businesses. The allocation rules for allocating expenses between exempt and nonexempt income are quite rudimentary compared to the great sophistication and development that's taken place in another area. And I speak here about the international foreign tax area. There the allocation rules comprise, oh, about 20 pages in the regulations with many precedents and examples built in. There is a great deal of complexity. There's much more revenue at stake in the foreign area, billions of dollars truly, $30 billion a year on the foreign tax credit alone. We could learn from that.

What's being suggested here is a rudimentary approach, which I don't think Treasury, put to it, would argue is fair or precise.

The question to be determined is whether the simplicity of it makes the administrative benefit outweigh the unfairness of it. But the end of their suggestion on allocation of expenses would be that expenses would never be allowed to exceed the income from the property. And that, of course, is completely the opposite of what happens in the for-profit world and the very reason why net operating losses exist in the code, to carry them forward from year to year.

If we mean to level the playing field, we ought to be careful to do that in a consistent way.

Mr. JACOBS. Mr. Shillingburg.

Mr. SHILLINGBURG. I want the committee to be aware of the fact that Treasury decided not to litigate further the issue in the *Rensselaer* case because they decided that they should revise the regulations on expense allocation. And so I think seeking a legislative cure is premature. But if the whole topic of expense allocation is open, Harvey Dale is right that there are better guidelines for expense allocation around, and they would be useful. Let's don't tinker with just part of it.

Mr. JACOBS. Mr. Hansmann.

Mr. Hansmann. Yes, I want to add something about the fragmentation rule, which is part of 3 here, which is that I think at the risk of offering some heresy for someone who is employed by the nonprofit sector, I think when it comes to shops that are selling items and so forth, there may be some point to consider whether or not maybe a museum gift shop, university bookstores, et cetera, ought to simply be considered taxable entities in the whole, and stop picking and choosing among the entities they sell as to whether or not the exemption should extend to them. And that is, I might be prepared to go further than the Treasury.

Mr. Jacobs. No. 4.

Mr. Dale. The controlled-subsidiary issue is funny. We're talking here about this sort of a model, a tax-exempt organization forms a subsidiary, and it, for example, licenses intangibles to the subsidiary.

If the tax-exempt organization had done the business directly, the profit would have been subject to UBIT. By licensing its wholly owned subsidiary, it can draw out of that subsidiary, through royalties, at least a very significant portion of the income that is deductible to the subsidiary and, therefore, not taxed there, and exempt from UBIT in the hands of the charity and, therefore, not subject to tax there.

That comment is true about each and every form of permitted passive income which also is deductible against the tax base of the payor. It's not limited to royalties.

The same is true for rent. The same thing is true for interest and other deductible payments. What is not clear to me is what control has to do with that. Control gives rise to the possibility of an unfair amount of compensation. Royalties, for example, could be too high. It could have to do with pricing. But, otherwise, whatever is involved in that, it seems to me, in terms of tax is neutral whether the subsidiary is owned or not.

Let me put the case another way. There is no reason why a university, for example, which is prepared to license a patent at a price that would use up all of the profits, could not do that to an organization owned by an independent person, as well as an organization owned by it itself because, presumably, on that model there is no profit left in the organization anyway. And if they did it to an unrelated organization, the issue, it seems to me, is the same, and I am confused about why the control test is being used and, in any event, why a more-than-50-percent threshold is being used. I am just not clear about that.

Mr. Jacobs. Mr. Hasson.

Mr. Hasson. Could I comment on that, please, sir.

To correct some misimpressions that seem to have abounded during the hearings, the issue of a controlled subsidiary focuses upon whether there is in fact a deduction at the subsidiary level with no taxable income at the parent level.

If you have a controlled subsidiary, there is a deduction at the subsidiary level, but the royalty or the interest that is received by the parent exempt organization is subjected to the unrelated business income tax under the law as now written.

The Treasury's diagnosis does not match its prescription. The Treasury says that the problem is that we are using a test that requires 80 percent ownership of all classes of stock and that it's easy to get around that limitation by having a small secondary class of stock that's issued.

If that's the problem, then that's what ought to be addressed. The changing of the percentage does not affect that if that's the problem.

Mr. JACOBS. No. 5.

Ms. ROSE-ACKERMAN. The basic issue that must be resolved: Why are Treasury and the Congress concerned about this issue? What is the problem with a nonprofit having subsidiaries and getting income for its primary purpose from these subsidiaries. If you think it's inappropriate somehow for them to be mixed up with this kind of activity, that's one thing. If it is a question of diluting management's devotion to the charitable purpose by spending too much time in the subsidiary. That's something else. But I don't think the Treasury has very clearly articulated why this is something to be anxious about.

Mr. SCHULZE. Maybe I can answer that for you.

Much that has been discussed in these hearings is the halo effect, is the appearance of a marvelous charitable organization which is in effect a profitmaking business, doing business as everybody else. And that is a great advantage.

Ms. ROSE-ACKERMAN. All right. So one part of the issue has to do with the misuse of the charitable deduction to gain profitable advantages—an issue that has to do with whether the institution deserves to be tax-exempt at all. But if it deserves to be tax-exempt, then it deserves to be tax-exempt because in fact it does have some kind of halo or something around it.

Mr. DALE. I think what you are worried about is the use by the not-for-profit of intangibles, its name or its logo, or something, to market products. That can be done as well through a nonwholly owned or a partially owned institution, and if we are worried about a halo effect, or the use of it, again, it does not seem to me to respond to a control test.

Mr. JACOBS. When you say nonwholly owned, how do you spell "wholly"? [Laughter.]

All right. Let's go to No. 5.

[No response.]

Mr. JACOBS. Let's go to No. 6.

Mr. HASSON. Yes, sir. On No. 6, again I believe that the Treasury has missed the point. The Internal Revenue Service rules and court decisions already tell us that if an exempt organization is providing services, the payment that it receives is not a royalty.

Now perhaps that could be aided by a codification or a direction to the Treasury to implement that position in the regulations. The suggestion of the Treasury Department does lead to one observation, and that is that the term "royalties" has never been adequately defined—has never been defined, period, for that matter—and there may well be different types of payments which today are called royalties, which should be treated differently under the unrelated business statute.

Mr. JACOBS. Seven. I am sorry. Mr. Shillingburg.

Mr. SHILLINGBURG. Thank you. On royalties, there is extensive learning on what is a royalty because the concept is used in the personal holding company area and the foreign personal holding company area.

I would not mind having the UBIT exemption narrowed so that a royalty cannot be based on taxable income. I have always told people that if they base their royalty on taxable income, even though the statute says that you can, they risk having a partnership. May I have been too really conservative. At any rate, I would give you that change immediately. But I certainly would not want to change the concept of royalty to tax a university of income from patents that have been developed under its research program, or to tax income from copyrighted software and so on. And I don't see why income from licensing a logo or a trade name should be taxable. Existing rulings distinguish that from service income.

Mr. Jacobs. Seven. Research activities.

Mr. Hasson. I will volunteer once again, Mr. Jacobs. Research is clearly differentiated from testing in the existing regulations and court decisions. That distinction is not well known and is not consistently applied.

It seems to me that an awful lot of the testimony that you heard from various engineering groups, research groups, and so forth, really dealt with testing which an organization claimed was related to its exempt purposes.

Perhaps you could look to the private foundation provisions where this committee came up with a procedure dealing with scholarships and fellowships, and perhaps an auditing approach that would facilitate dealing with this issue would be to require that an exempt organization specify in advance, in its own internal records, what relationship particular testing may have to its exempt purposes, whether that be the involvement of a certain number of students in a training exercise, or the collection of a certain number of specimens needed for medical research.

Then, with that record having been established in advance, the Internal Revenue Service would have a standard against which to compare the activities of the organization when it comes in at a later date.

Mr. Jacobs. No. 8. Joint ventures.

Mr. Shillingburg. I would like to point out that partnerships have become the preferred form of business organization, particularly since the 1986 act. The Treasury seems willing to take us back to the late 1970's, when the IRS had considerable doubts about exempt organizations being in partnerships.

I think the IRS has come a long way since to understand partnerships. I think the country, as a whole, has come a long way. I would like to have the test not be that an exempt organization should be taxable because it is in a partnership, but rather, that it is going to be taxable because of some quality of income that it is getting through the parternship.

Mr. Jacobs. Professor Dale.

Mr. Dale. I guess I agree with Mr. Shillingburg, but with a caveat, and that is that I do not think that the partnership or joint venture rules are working. I understand we are here, rather than the other conference room, because the other room is being occupied with hearings on master limited partnerships, and for good reason. That is a very important subject.

I think the partnership rules are close to breaking, and that the repeal of *General Utilities* has contributed to that, and it is not clear where that plays out.

I think that the developing law, and sophistication of tax planners is putting tremendous pressure on the partnership form, and I would share Treasury's concern without disagreeing with Mr. Shillingburg, but believing that this is an appropriate time to pay rapt attention to joint venture and partnership formats.

Mr. HASSON. I agree in part with both of the former speakers, but I would like to point out for the committee's information, that the Treasury testimony on this subject ignores its own recently adopted regulations which require that all partnership allocations have substantial economic effect.

Under those regulations, the hypothetical example in the Treasury testimony is not possible if the partnership utilizes nonrecourse debt, which is the typical situation.

Even if the partnership does not involve nonrecourse debt, if it is an all-cash or a recourse debt deal, the Treasury testimony example, works only if the taxable partner is fully at risk for losing its investment in the partnership. That is the so-called negative capital account makeup provision required by those new regulations.

Certainly, abuses should be looked at, but they should be looked at accurately and completely to identify what they are.

Mr. JACOBS. That pretty much dissolves us into the final, the number nine. Do you have any further comment on that?

[No response.]

Mr. JACOBS. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman. Relatedness seems to be one of the keys to a solution. The determination of degree of relatedness, it seems to me, is going to be a very difficult line to draw or problem to solve.

For example, lets say I own a small museum and it has antique soldiers, or antique banks such as these little banks that you put coins in when the dentist pulls the tooth. I have been collecting these all my life, and I have a home by the side of the road and I open up a museum for banks.

And along with this, as time goes on, I establish a nonprofit museum that grows. People come, and people say, can I buy any of these, or replicas of these? No, we do not have any, and, finally, we branch out and we find some. We put a little spot over in the corner where people can buy them, and that helps pay the costs because we were losing money before, and now we are just breaking even.

And along comes a slick salesman, and sells me a catalog or a little print, and I put that out and send it around the neighborhood, and soon I am selling a lot more of them.

And so the next year I put out a 150-page four-color, six-color, slick catalog, and buy all the mailing lists, and I sell it out all over the country. Suddenly, I am selling $8.4 million worth of these little banks each year. At what point do we draw the line? Is that fine? Is it good that, now suddenly, I am paying myself $600,000 a year because I deserve it? I have run one heck of a museum and I have got a very successful little museum going here.

I have been able to cut the cost to people coming in from a dollar to 50 cents, and we will even pay to bus in school children to see these banks. Doing all kinds of nice things for the community.

Is there a point at which we should draw a line on that type of an operation?

Mr. DALE. I have one comment on that. Law professors always ask that question hoping that some student will answer them. It is hard to draw those lines. But I take it what you are after is the question, at what point the tax-exempt status is lost. And one observation is that the very purpose of the UBIT, or a function of the UBIT is to have a halfway house. So that instead of having everything turn on tax-exemption or full taxable status instead of just black and white, we have a place in the middle where tax-exemption is not at risk.

And some portion of the activities can be subject to tax and you have clearly described that. Another observation to make about that is that we have to be careful in dealing with the tax-exemption rules, and this is unfortunate—I have a specific recommendation about that, it stems just from your example.

Too much of the Federal definition is borrowed for other purposes outside of the tax law. Postal rates, State and local taxes, real estate taxes—on and on and on.

They have borrowed the definition uncritically, and without a halfway house. There, it is yes, yes, or no. If you have 501(c) standards, you have got it. And as we play with the UBIT, we change the description of the sector, and all of that freight is coming behind us. It is as though you are a ship in the water with a scow slowing you down.

If you could—you cannot do too much, it seems to me, with the 10th amendment, as to the State rules, only you could encourage it—but in the federal system you could, and you might consider the cost-benefit analysis of decoupling. That you could do.

And if you left the tax definition to serve the tax purpose, and tried not to have other things carried with it, you might be somewhat more free to legislate without undue impact in places where you were not looking.

The bad news about that, of course, is that it is going to get everybody nervous while the other agencies invent their own definitions.

Mr. SCHULZE. Mr. Shillingburg.

Mr. SHILLINGBURG. You have put an intriguing example, and I guess the way you presented it, you expect a UBIT answer, but I think the answers——

Mr. JACOBS. It seems to me that relatedness, it is related all the way through every——

Mr. SHILLINGBURG. I don't think that the organization is exempt in view of the excessive salary paid.

When the Service took on the museum shop area in the late 1970's, and pulled in probably 20 cases, and along with it some small organizations who just sort of got caught in the process, I do not think they saw your case. They saw some very large institutions who had catalogs, but were not making the kind of money that I think your example implies, and, certainly, their officers were not making the kind of salary that your example indicated.

They pulled in some small organizations who were basically selling curios, or local memorabilia, souvenirs and they got caught with a tax liability.

I also want to point out fact, by establishing your successful entity in the form of a (c)(3) organization, you have set it away from your family as an asset.

The museum shop area is one which the Service went into, I think, with considerable concern, did a lot of investigation—it took several years, and there were a lot of tension in the museum area—and emerged with conclusions that there was not much tax able activity going on there. The tension was over the possiblity that tax relatedness guidelines adopted in 1973 would be interpreted so as to impose tax liabilities retroactively. I think that organizations are entitled to certainty in the UBIT area just as all taxpayers are entitled to certainty.

Mr. SCHULZE. Should our role be to create some sort of dynamic tension, to say we realize there is a potential for abuse out there, and we are going to be vague, but we do not want you to step over that line. Do we serve a good service——

Ms. ROSE-ACKERMAN. But the potential for abuse that you are particularly pointing to, it seems to me, is that the man is paying himself $600,000. The founder of the museum might do this either because of the successful selling of banks that are related to the museum or because a rich widow dies and leaves this museum $2 million.

Mr. SCHULZE. But don't we get into trouble there, though, saying you cannot pay yourself more than *x*, and we are then determining what——

Ms. ROSE-ACKERMAN. Yes.

Mr. SCHULZE. Maybe this fellow worked 18 hours a day and he shined those things, and——

Ms. ROSE-ACKERMAN. Yes. There are certainly lots of problems with any policy. But it is not obvious that the difficulties would be greater than making a distinction, as the IRS must currently do, between, for example, selling earrings and selling books, in a college book store.

Mr. SCHULZE. Mr. Hansmann.

Mr. HANSMANN. Well, I think your examples points up a very good issue, and I think we get misled by our kind of physical notion of relatedness. This thing, selling reproductions of something in the museum, we somehow think that is related because it looks like—these little banks look like something that is in a museum.

I think the question here for relatedness should be the same question as for the basic exemption. Is this an activity for which the nonprofit corporate form is peculiarly suited, but cannot be as well conducted by a for-profit firm? If this little museum could just as easily license the right to make these reproductions to a for-profit firm which would itself invest in the business, manage the business, sell the catalogs, and so forth, and could market these things, reproduce and market them just as well as your museum could, there is no reason to encourage a nonprofit to do it.

There may be no reason to discourage it, to outlaw it, to put punitive taxes on it, but I think there is some reason to say if a nonprofit is going to go into this business, it should be taxable, and it should hive it off—and it does not matter at what scale—it should hive off its little shop as a separate entity. It should do separate accounting for it and pay corporate taxes on it, and just as if it bought a share of IBM, and IBM does not get excused for taxes just because this little endowment owns some of its stock, I think.

Mr. DALE. You suggested, or maybe it was suggested at an earlier panel, that a line could be drawn, but without giving up what you call tension. It is possible, I suppose, to draw a line as an alternative to but not in substitution for a facts and circumstances test. If that were to be done, I think it has to be drawn very carefully, and almost certainly not by reference to gross income or gross receipts. Those are too manipulable and will not serve the purpose.

But if you wanted to create a line, any line will do, that the Congress chooses to do, I simply suggest that that should not be in lieu of a facts and circumstances test because the simplicity of it will fool us.

Mencken once said that for every complicated problem there is a solution which is simple, elegant, and wrong.

Mr. SCHULZE. Thank you, Mr. Chairman.

Mr. JACOBS. Mr. Hasson mentioned a term considered by the Government, I think in 1942. I am wondering, particularly, Mr. Hansmann, from your comments, would the panel be interested in returning to the thrilling days of yesteryear and revisiting the necessarily incidental description or definition.

Mr. HASSON. Well, in my reading of the hearings of the 1940's, which were when development of tax legislation took a decidedly slower pace than in the 1980's, the original 1942 proposal from the Treasury Department was to utilize a standard of not necessarily incident to.

In the hearings in 1947 and 1948, the subject was again examined by the Ways and Means Committee, and during the course of those deliberations, the suggestion was that that test, the Treasury proposal, was too limiting, that it would preclude many institutions, universities, for example, from carrying on traditional revenue-generating activities such as the student laundry.

As a result, many of the spokesmen that came before the committee in 1947 and 1948, including a representative of New York University, stated that the test should be one of "direct connection with," or "not directly connected with."

Thereafter, the committee took the luxury of 2½ or 3 years before coming up with the statutory language in 1950, and during that period of time it was determined that the test "not necessarily incident to" was too stringent, that the standard "directly connected with" was too lenient, and that there ought to be something that is more than just a direct connection.

Therefore, they came up with this concept of "substantially related to." The Treasury thereafter said, "substantially related"—they got around to that in 1967—means that the activity "must contribute importantly" to accomplishing the organization's exempt purposes.

So I think your history will show you that there has been considerable debate over the meaning of particular terms. I do not know that it really advances us much to adopt another standard, since we have 40 years of administrative and judicial attention to the current standard.

Mr. **Hansmann**. If I may just offer a comment. I do not think that either of these verbal formulations, or any of them that we have historically played with necessarily is helpful if you do not understand what is it you are being related to, what the point is, if this purpose is served, and again I would just reiterate that I think that the critical question has to be why do we give an exemption to this activity.

And the related activities have to be exempt for the same reason. If the museum is providing cultural services that would not be provided by the market, then we have got to ask whether the sale of reproductions is also performing such a function. If it is not, it could be done just as well by a for-profit firm, remove it, but the "substantially related" has to be related to that public good that is being provided by the entity, that would not otherwise be provided.

So I think verbal formulations are not helpful unless you understand what they are getting at.

Mr. **Jacobs**. For the record, the contribution of this panel has been educational and crisp, and therefore usable, and you have enriched the record. The committee is grateful, and adjourned.

[Whereupon, at 11:29 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF GEORGE T. DEBAKEY, EXECUTIVE DIRECTOR, ADAPSO, THE COMPUTER SOFTWARE AND SERVICES INDUSTRY ASSOCIATION

ADAPSO is the trade association of this nation's computer software and services industry. ADAPSO's 950 corporate members and industry provide the public with a wide variety of computer software and services including software for mainframe, mini-, and microcomputers, custom and contract programming services, consulting services, local and remote data processing and services, and integrated hardware/software systems. ADAPSO's members and industry compete in many instances with nonprofit organizations and public entities. ADAPSO thus has a significant interest in the subject of unrelated business income tax (UBIT) and in the outcome of this hearing.

ADAPSO has as one of its principal goals the maintenance of a fair and competitive industry. To this end, ADAPSO is a member of the Business Coalition for Fair Competition (BCFC), an alliance of trade and professional associations and businesses that share a common concern over the growing number of nonprofit organizations competing unfairly against the private sector. BCFC members support the effort to eliminate unfair competition and do not seek to obstruct the legitimate goals of tax exempt organizations. From its inception in 1983, the BCFC's aim has been to help small business, not to harm nonprofits.

ADAPSO supports the solutions to the nonprofit competition problem recommended in the testimony submitted to this subcommittee by Joseph O'Neill, Chairman of the BCFC. In particular, ADAPSO agrees that a more appropriate test for exemption from taxation is needed. The UBIT is simply not correctly focused. A more appropriate test would be to examine what the activity is rather than what purpose the income serves. In addition, ADAPSO supports the changes to Section 501(c)(3) and the addition of a new Section 501(n) recommended in the BCFC testimony.

Nonprofit competition is not a new issue for ADAPSO. As far back as 1972, ADAPSO objected to Dartmouth College's plans to enter the timesharing business. In that case, through negotiations, Dartmouth agreed to spin-off the entire program, and created a private, taxpaying company, DTSS, Inc. I am pleased to say that today, DTSS is even a member of ADAPSO. DTSS is a prime example of one of ADAPSO's strongest convictions, that nonprofit organizations should not engage in competitive commercial activity, except through a maximally separated operating structure.

Over the past several years, the commercial activities of state university exension programs in computer software and services has grown at an alarming pace. For example, in 1985, Stoner Associates, a small engineering software company located in Carlisle, Pennsylvania, became concerned about software developed by professors at the University of Kentucky and its College of Engineering. Stoner Associates produces specialized engineering software packages. Stoner Associates and ADAPSO found that the University of Kentucky and its College of Engineering was subsidizing through its extension service, what was essentially the private, commercial development of software. The University was using its facilities and resources, not to mention its nonprofit mailing privileges, to promote the commercial activities of these professors. The software was only available directly from the professors, but training, which is essential to the operation of this software was provided by the University and taught by the same professors. The University was offering low cost services to its professors, and in essence subsidizing their commercial venture. The University of Kentucky continues to compete unfairly in the engineering software market, despite all efforts to stop it.

On another front, the National Science Foundation's (NSF) Division of Advanced Scientific Computing (DASC) has financed five university supercomputer centers. A DASC policy (Important Notice No. 91, March 11, 1983) outlines the allowable use of NSF-supported supercomputers by forprofit organizations. The policy specifically states that the National Science Board recognizes that there may be circumstances where NSF grantees use NSF-supported research instrumentation to provide services for a fee, but that it is contrary to the NSF's intent for grantees to use NSF-supported research instrumentation or facilities to provide services for a fee in direct competition with private companies that provide equivalent services. Unfortunately, a NSF memorandum dated June 10, 1985, which elaborates on Important Notice No. 91 states that DASC policy allows NSF-supported supercomputer centers to allocate up to 10% of the total machine resources to "proprietary research". Moreover, ADAPSO has been informed by the NSF's DASC that each supercomputer center has a unique arrangement with the NSF for the provision of commercial computer services. ADAPSO believes that the commercial usage of the NSF supercomputer centers and other public computer centers pose a serious threat to the remote processing services industry. ADAPSO's position is that the services provided by the NSF supported supercomputer centers that are readily available in the commercial market should not be exempt from Federal taxation.

The threat posed by the commercial activities of the NSF-supported university supercomputer centers was brought to ADAPSO's attention by Solution Systems, Inc. (SSI) a small business located in Narberth, Pennsylvania. The NSF-funded John von Neumann National Supercomputer Center in Princeton, New Jersey, is offering computer services to private industry in competition with commercial remote processing companies. SSI is concerned that the commercial services provided by the John von Neumann Supercomputer Center and the other NSF-financed supercomputer centers have decreased the industrial user base for commercial vendors and have further decreased the user base by encouraging the repeat business of industrial users.

For example, a major pharmaceutical manufacturer informed SSI personnel that they intended to buy supercomputing services from the John von Neumann Supercomputer Center because they believed that they would be supporting Princeton University and that the services would be much less expensive.

In addition, a national financial services firm and an international petrochemical company reported that they are buying supercomputer time from the University of Minnesota's "resource center". SSI offers the same services and is extemely competitive in the commercial arena, but cannot compete with the subsidized services offered by the University of Minnesota. SSI president Neil Kleeman believes that government subsidized supercomputer services should be used for, "basic non-proprietary reseach", and should not be available on a commercial basis in direct competition with the private sector.

SSI and ADAPSO have sent a joint letter to the NSF-supported supercomputer centers to inquire about their commercial activities with the intent of combating those activities which are unlawful or unfair.

ADAPSO members have also encountered unfair competition from state governments. For example, in New York State, the Research Foundation for Mental Hygiene, Inc. (Foundation) operates with unregulated State funds and develops and markets software and associated services to mental health facilities both within New York and in other states. Because New York State agencies serve as a pre-sold "installed user base", it is extremely difficult to compete with the Foundation for public and private agency sales. Computer Psych, Inc., a small business in New York City, has informed ADAPSO that through the Foundation, New York State funds are being used to support a virtual monopoly on software for the mental health field in New York. The Foundation's tax obligations are significantly less than the private corporations they compete against.

Another example of state competition is the Minnesota Educational Computing Corporation (MECC) which sells millions of dollars worth of microcomputer software to schools throughout the United States. MECC is an extension of the State of Minnesota and is exempt from state and federal taxes. MECC competes with many small educational software firms that are subject to taxation. MECC has a virtual monopoly on educational software in Minnesota and is in a very strong position in the U.S. market. Private computer software vendors cannot compete effectively in the educational software market with MECC because of the special privileges it enjoys as a nonprofit. These privileges include exemption from income, sales and property taxes, and the use of the nonprofit name. To some, unfortunately, a nonprofit name makes the product or service appear fairer, to be better, purer, less subject to the corruption of the private sector. These privileges create a distinct business advantage over their forprofit, taxpaying competitors. Because the MECC is competing so completely in the educational software industry, the tax exempt status of their commercial activities should be reviewed by the Federal Government.

In conclusion, ADAPSO does not question that there is a role for universities and government to play in the computer software and services industry. Our members and industry rely heavily on colleges and universities to train highly qualified programmers and systems analysts. The computer software and services industry has historically contributed much in the way of resources to colleges and universities. ADAPSO believes that the exemption from Federal corporate income tax under Section 501 of the Internal Revenue Code is a privilege not a right, and should be subject to limitation. Under the UBIT as currently defined, it is difficult to discern where education activities end and the commercial activity begin. ADAPSO is very appreciative of this subcommittee for re-examining the uncontrolled growth of tax exempt organizations that compete unfairly with private industry. It is reasonable to expect that the commercial activities of tax exempt organizations will continue unless public policy is revised to correct the terms of competition.

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COMMITTEE ON
RECEIVED
JUL 2 1987
WAYS AND MEANS

June 30,1987

Chairman
House Ways & Means Committee
Sub-committee on Small Business
Washington,D.C.

Dear Sir:

I read in the Wall Street Journal of the hearings being held, regarding the invasion by many non-profit public agencies into the realm of ligitamate for-profit business organization.

I concur with the stated aims of the hearings, to bring to the public attention this insidious practice.

We have witnessed and been affected by such an agency, with extreme hardship resulting from such an unfair competitor.

It is incongruous to think that the taxes we pay are disbursed in such a manner, as to result in setting up a competitor for the same clients we are serving.

If we can be of any aid in furthuring this matter of investigation please do not hesitate calling upon us.

Yours truly,

James L.Sunstein

Comments of the
American Bankers Association
Submitted to the
Ways and Means Subcommittee on Oversight
July 16, 1987

The American Bankers Association is pleased to submit comments in connection with the Subcommittee's hearings on the unrelated business income of tax-exempt organizations and the unfair competition between tax-exempt organizations and taxable businesses. The ABA is the national trade and professional association for America's commercial banks of all sizes and types. Assets of ABA member banks are about 95 percent of the industry total. Congress has addressed this competition issue before, and has on several occasions concluded that tax-exemption for a particular class of organizations was no longer justified. For example, in 1951 the tax exemption for mutual savings banks and savings and loan associations was repealed. During this review American Bankers Association urges the Congress to reconsider and repeal the tax exemption provided for credit unions.

When tax-exempt status was granted to credit unions, they were small mutual benefit organizations that enabled individuals with a common bond to pool small amounts of savings in order to obtain better savings rates, and to obtain easier and less expensive loans. Over the years, credit unions have grown enormously in size and diversity. This growth has blurred the historical differences in activities between the tax exempt credit unions and taxable financial institutions so that the tax exemption is no longer warranted. The changes that have eroded the uniqueness of credit unions have occurred in three key areas: erosion of the Financial stake, deterioration of the common bond, and the growth of new products and services.

Erosion of Financial Stake

Introduction of Federal share insurance in 1971 significantly altered the nature of credit unions, so that members no longer have the same financial stake in the success of the organization. In the early history of credit unions, emphasis was placed on the fact that depositors stood to lose some of their own funds if some borrowers did not repay their loans. Risk of loss of one's own funds provided strong incentive for repayment of loans and close supervision of the lending function, creating an important link between the lending side and the deposit side. Share insurance has severed the link, because credit union members can now look to federal insurance to protect them against risk of loss. The incentive for close supervision of loans has been weakened and some of the motivation for emphasis on good repayment habits has been eliminated.

Deterioration of the Common Bond

Changes in the common bond requirement for credit union membership by the National Credit Union Administration (NCUA) and state regulators allow credit unions to compete with banks and savings and loans for customers among the general public. The NCUA stated that deregulation of the field of membership policy began in April 1982, but the common bond requirement had been loosely interpreted for many years before that date. For example, in 1968, authorities ruled that a person could continue to be a credit union member even after the common bond was severed.

Other changes which have eroded the traditional common bond characteristic include deregulation of the immediate family definition to include family members who do not live in the same household, elimination of the requirement for similar common bonds in multiple groups charters, and expansion of the geographic area that may be served by a multiple group charter. Geographic limitations have been relaxed to include "an area surrounding the home or branch office that can reasonably be served by the applicant," rather than the previously required well defined area.

Credit union expansion toward soliciting the general public is also demonstrated by the fact that since 1984 federal credit unions are encouraged to sponsor and assist in forming associations or clubs of senior citizens and/or retired persons where they do not exist in order to provide service. This policy is an outright exception to NCUA field of membership rules that the primary purpose of the formation of an association may not be to provide credit union membership to association members. The ABA objected to the new policy because it is clearly outside the intent of the law regarding common bond membership.

According to NCUA, "the essential basis for all the changes in the field of membership policy since April 1982 is to provide credit union service to people who do not presently have credit union service available to them." This is, in effect, an admission that there really is no field of membership limitation.

Growth of New Products and Services

Credit unions have also evolved beyond their traditional mutual benefit savings and loan product offerings into full service financial organizations. An August 30, 1985 Wall Street Journal article concluded that:

> "....while consumer lending is still their bread-and-butter business, some of the larger credit unions have recently been offering such gourmet fare as credit cards, individual retirement accounts, discount-brokerage services, automated teller machine networks and computer-authorized loans."

Even executives from credit unions with assets as low as $1 million indicate that they are positioning themselves as "full service" financial institutions in an annual survey by Users, Inc., a data processing service company.

A provision of the conference report on H.R. 27, the 1987 Competitive Equality Banking Bill, which will soon be voted on by Congress, will make credit unions competitive in the quest to attract public unit deposits. Public unit deposits are deposits of all units of governments. Prior restrictions on credit union pledges made such government bodies reluctant to deposit more than $100,000 in credit unions, and in some jurisdictions there has been a movement to make such restrictions statutory. In order to counter these moves, the credit unions sought and obtained legislation that permits them to pledge assets other than loans to secure public deposits.

Summary

The nature of credit unions has evolved from the mutual benefit organization established to promote savings and consumer loans to today's full service financial service organization with "checking" accounts, ATM machines and credit cards, real estate loans, and public deposits. The competition is substantial, especially for community banks. Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loans. This tax-exempt status has enabled them to grow rapidly.

Since 1962 credit unions have enjoyed an annual growth rate higher than the growth rate for other financial institutions. The 1986 growth rate was double the deposit growth rate for commercial banks. Between 1979 and 1986, combined assets of all credit unions grew from $61 billion to $157 billion, and total assets stood at $175 billion in March 1987. The figures for loan growth and membership growth are also impressive.

The changes in the operation and customer base of credit unions caused the Administration to recommend repeal of the tax exemption for large credit unions as part of "The President's Proposal for Fairness, Growth and Simplicity." The proposal noted that, "in an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions should generally be subject to tax on the same basis as other financial institutions."

The American Bankers Association agrees. The irony of the tax exemption for credit unions is apparent if you consider the rules on accrual of income on short term loans earned by small banks which are otherwise on the cash method for tax purposes. The small banks will have to pay tax on interest income even before they receive it, whereas the credit unions with which they compete won't have to pay tax on interest income at all.

The American Bankers Association recommends that as part of its review of tax exempt organizations which use their tax-exempt status to unfairly compete with taxable business, the Committee consider and repeal the tax exemption provided for credit unions.

American
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Association

ADA

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July 17, 1987

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
242 Cannon House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

I am writing to express the views of the American Dental Association regarding tax policy respecting income-producing activities of tax exempt organizations.

As a tax-exempt organization under the Internal Revenue Code section 501(c)(6), the Association believes that, in the main, current regulations are in the clear public interest and should be continued. To the extent that the Treasury Department concern with these regulations stems, in fact, from the adequacy of their enforcement, attention should be directed toward improvement of the latter rather than modification of the former. Improved enforcement, including more thorough data collection efforts, would, among other results, establish the informational base that is necessary for sound decision-making regarding the appropriateness of the regulations themselves.

Proceeding from this basic position, we offer the following observations regarding proposals that have been presented for the Subcommittee's consideration.

Aggregation of Activities: The question has been posed as to whether or not the activities of an exempt entity should be aggregated with the activities of its for-profit affiliates to determine whether or not the primary purpose of the exempt organization is to carry on a business unrelated to the organization's exempt purpose.

We believe that the aggregation of the activities of an exempt entity's for-profit subsidiaries with exempt activities is improper since it bears no relevance to the question of whether or not the activities of an IRC 501(c)(3) organization or a trade association under IRC 501(c)(6) are of the type for which exemption should be granted. Furthermore, those who advocate the aggregation of such activities ignore many of the realities of the environment in which exempt organizations operate.

The Treasury's concern arises over the fear that an unrelated business, operated through the use of a for-profit subsidiary, may supplant the organization's exempt purpose. We believe the Treasury's fear is unfounded. An association's decision to set up a for-profit subsidiary is usually governed by a valid belief that in some way the activities of the for-profit affiliate will contribute toward the association's exempt purpose.

We believe that the only additional revenue to be raised by aggregating the activities of an exempt organization with the activities of its for-profit affiliates would result from the taxation of a valid exempt activity. Activities not related to the organization's exempt purpose are already subject to taxation. In addition, aggregating the activities of an association with those of its for-profit affiliates would present the difficult question as to what is the proper method to measure the extent of an organization's exempt activities. To simply compare the revenue and expenditures of an association with those of its for-profit affiliates would ignore those services which have been volunteered. The value of these volunteer services cannot be easily quantified. Yet, these types of volunteer services are usually an integral part of an association's activities. We believe legislation recognizing volunteer services such as membership committee work, should be considered in determining the organization's primary purpose.

Significant confusion has resulted when the courts have attempted to determine the proper measure of an association's exempt activities in the context of unrelated business activities within the association (see Associated Master Barbers & Beauticians of America, Inc., 69 TC 53 (1977)). The introduction of the activities of for-profit subsidiaries into this complex analysis would only open a Pandora's box. The result would be greater confusion in an already imprecise area.

When an association's for-profit affiliates operate as separate and distinct companies, we see no valid purpose served by "piercing the corporate veil" and attributing the for-profit affiliates' activities to their exempt parent. For these reasons, we request Congress to provide guidance by indicating that activities of a for-profit subsidiary not be attributed to the exempt association when determining whether or not the association's activities are consistent with its exempt purpose and that volunteer service be considered in determining the exempt purpose.

Allocation Between Exempt Activities and Unrelated Business: Closely related to the issue of the proper method of measuring the exempt activities of an association is the use of a proper method to allocate the expenses of the association between exempt activities and those activities unrelated to the association's exempt purpose. Unrelated business income is defined as gross income derived from an unrelated business less allowable deductions "directly connected" with the carrying on of the unrelated trade or business. Where facilities and personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities the regulations provide that the expenses and costs shall be allocated between the two uses on a reasonable basis.

A rigid required allocation method may not always reflect the true economics of a given situation. This could be true whether or not the allocation method was based upon time spent on unrelated activities vis-a-vis time spent on exempt activities, time spent on unrelated activities vis-a-vis total time available, or any other required allocation method. A clear example of a required allocation which bears little resemblance to economic reality is the allocation of a portion of members' dues to publishing expenses as required in Treasury Regulation 1.512(a)-1(f)(4).

For those reasons, we recommend that the regulation regarding allocations between exempt activities and unrelated activities be maintained.

Allocation of Membership Dues to Circulation Costs: IRC 513(a) defines an unrelated trade or business as "any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its (exempt purpose)." According to IRC 513(c), which deals with advertising, "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." The Supreme Court in interpreting IRC 513(c) has ruled that "...the publication of paid advertising is a trade or business activity distinct from the publication of accompanying educational activity and editorial content." (see U.S. v. American College of Physicians, _ U.S. _, 106 S. Ct. 1591 (1986)). Congress, in IRC 512(a)(1) has defined unrelated business taxable income as "the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business..."

Where the sale of advertising in a publication of a tax-exempt organization is carried on in conjunction with an exempt function, Treasury Regulations describe in detail the appropriate methods for computing unrelated business income. The regulations require two computations to determine to what extent advertising revenues constitute unrelated business income.

1. Income or loss from advertising is computed by subtracting direct advertising costs from advertising income.

2. Income or loss from circulation is computed by subtracting readership and other costs from circulation income.

If the sum of advertising income less direct advertising costs results in a loss, it can be used to offset other unrelated business income and can be carried back or carried over. If the sum of advertising income less direct advertising costs results in a gain, it is unrelated business income to the extent it exceeds any loss from circulation. If the loss from circulation exceeds the gain from advertising income less direct advertising costs, the loss cannot be used to offset other unrelated business income and cannot be carried back or over (Regulation 1.512(a)-1(b)).

It is crucial to note that where the right to receive a periodical is associated with membership, circulation income also includes an allocable portion of membership dues (Regulation 1.512(a)-1(f)(3)(iii)). Treasury Regulation

1.512(a)-1(f)(4)(iii) sets forth the method to use in allocating a portion of membership dues to circulation income. Because the portion of membership dues allocated to circulation income is generally high, exempt organizations usually show net income from circulation rather than a loss. As a practical matter, the required allocation of membership dues results in net advertising income not being offset by any readership or other costs.

Clearly, IRC 512(a) and 513(a)(1)(C) contain broad language creating an appropriate area for Treasury Department interpretation. However, the regulations promulgated by the Treasury pursuant to IRC 512 subject exempt organizations to taxation even if they lose money on their periodicals. This creates practical ramifications that certainly were not endorsed by Congress and should, if not amended, be the subject of Congressional legislation to correct their unjustly harsh results.

Trade publications, such as professional journals and the like, do not usually realize a profit. The cost of publishing the periodical exceeds the advertising revenue that it generates. The regulations, by creating an artifical, complex allocation system, squeeze substantial amounts of unrelated business income from publications which are not profitable. Nothing in the legislative history indicates that Congress desired such a harsh and unfair result.

Furthermore, the types of periodicals covered by the regulations are not of interest to the general public. Consequently, no viable retail market exists for the periodicals. In fact, similar publications are often distributed free of charge to the general public. Therefore, there is no valid rationale for allocating a portion of membership dues to circulation income. A member, upon joining a trade association, does not "buy" the association's periodical, but rather, membership status entitles a member to receive a variety of valuable goods and services, including trade journals.

Therefore, we request that the regulations dealing with advertising income be superseded by Congressional action. In this way, true Congressional intent will be achieved.

Supreme Court Interpretation of Advertising Regulations: Even if Congress agrees with the regulations regarding advertising as promulgated by the Treasury, we believe a recent Supreme Court interpretation of those regulations is contrary to Congressional intent and should be legislatively overridden. In U.S. v. American College of Physicians, _ U.S. _, 106 S. Ct. 1591 (1986), advertising income in a monthly medical journal was deemed taxable as unrelated business income because the advertising was not substantially related to its tax-exempt purpose. We do not agree with the Supreme Court's analysis. We agree, however, with the lower Court's analysis of the case. The lower court ruled that advertising in a medical journal need not be primarily educational in character in order to contribute importantly to the exempt purpose of education and therefore be substantially related and not taxable as unrelated business income. U.S. v. American College of Physicans, 743 F.2d 1570 (Fed. Cir. 1984), rev'd. _ U.S. _, 106 S. Ct. 1591 (1986).

Advertising, along with editorials and articles in trade journals, inform readers of current products and recent methods that may be available in their trade or profession. Since one of the exempt purposes of this organization is to maintain high standards in medical education and practice, physicians' remaining up-to-date on items advertised furthers this purpose of the organization.

The Supreme Court, however, decided that some of the advertising was for established drugs or devices and that ads were repeated from month to month and therefore were not contributing to the educational value of the journal. We believe the repetition of an ad does not take away from its educational value. Studies have shown that repetition of an ad dramatically improves the reader's retention of the ad's message. Moreover, a new or occasional reader may not have seen the advertisement in previous months. Advertising the established drugs along with newer experimental drugs enables the physician to compare the benefits or possible side effects of different products and generally allows the physician to make a more informed decision. Generally, a physician's time is occupied with patients; the ability to pick up a journal and peruse the advertisements could be invaluable to the physician's education. Similarly, advertisements in other professional journals contain educational content which results in substantial indirect benefit to the general public.

In summary, the general public benefits indirectly from knowledge gained by readers of trade journal advertisements. Unlike commercial advertisements, these journal advertisements relate only to the trade of the magazine and are read specifically by those in the same trade. We believe that the informational content of these advertisements furthers the knowledge of those in the profession and hence furthers the educational purpose of the tax-exempt organization. Therefore, advertising income in a trade journal should not be considered unrelated to an association's exempt purposes.

Investment Income: The Treasury recently has discussed passive income of trade associations. Treasury believes the investment income of a trade association should be treated in a manner that is neither more nor less beneficial than the treatment such income would receive if earned separately by the association's members.

The Treasury agrees that the association's members would be entitled to a deduction for association expenditures if they had incurred such expenditures on their own. To the extent that association expenditures would be deductible if incurred directly by its members, the Treasury agrees that an exemption of investment income may produce the same practical results as if the income were earned and expenditures incurred directly by members. Nevertheless, the Treasury believes that if the expenditures are deductible to the extent investment income is earned in one year and spent in a later year, the exemption effectively provides the benefit of a deduction before the expenditure is actually made. Because of this minor timing difference, the Treasury believes that the law relating to the exemption for passive income should be altered with regard to trade associations.

We believe that Treasury's position is without merit. The incremental increase in revenue that would result from removing the exemption for investment income of trade associations would not be sufficient to justify a change in the law. Any tax increase incurred by an association would be passed along to its members in the form of increased membership dues. In turn, the dues would be deductible by the membership on their individual returns. The net effect would be no additional revenue.

More importantly, Treasury's analysis ignores the Congressional intent behind the exemption for passive income from unrelated business tax. The legislative history of the unrelated business tax provisions indicates that Congress did not intend and has not authorized taxation of the passive receipt of income. In 1950, the Senate Finance Committee observed that unrelated income tax was to apply to income arising from active business enterprises which are unrelated to the exempt purposes of the organization. The Committee indicated that the "problem at which the tax on unrelated business income is directed is primarily that of unfair competition." (S. Rep. No. 2375, 81st Cong. 2d. Sess. (1950).) Specifically, with respect to the exclusion for passive sources of income, the Committee stated:

> "Dividends, interest, royalties, most rents, capital gains and losses and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are passive in character and are not likely to result in serious competition for taxable businesses having similar income." (S. Rep. No. 2375, 81st Cong. 2d. Sess. (1950) at 30-31.)

Like the investment income of all exempt organizations, the investment income of a trade association represents neither unfair competition nor unfair utilization of the association's assets. Rather, income derived from association investment is usually used to provide additional services and aid to its members. Such use of investment income is directly connected with the exempt mission of the association.

Therefore, we urge that regulations with respect to investment income of trade associations be maintained.

Royalties: Royalty payments to exempt organizations is another area in which the Treasury has expressed concern. Like investment income, the receipt of royalty income is a passive activity for which Congress granted an exemption from unrelated business income tax, on the premise that owners of the intangibles do not compete with taxable ventures with respect to the sale of assets for future royalty payments.

Nevertheless, the Treasury has indicated that a change in the definition of exempt royalties is warranted. We disagree. The statute excludes "all royalties" whether measured by production or by gross taxable income from the property. Congress specifically did not narrow this definition since royalties, from whatever source derived, do not compete with for-profit companies and are purely passive income. An organization does not actively conduct a business when it sells its intangible property for share in the royalty payments. When an exempt entity obtains royalty rights, a potential active business venture of an exempt organization has been transferred to a new owner, and all future business risk, gains, and operating costs will be incurred by the new owner. Since the exempt organization no longer participates in an active trade or business following transfer of intangible rights, the royalty payments it receives should not be taxable as unrelated business income.

Because of the passive nature of all royalty income, we believe that the current exemption for "all royalty" receipts is proper.

Encourage Greater Voluntary Compliance: It is our belief that the information required for Form 990, the basic information return for exempt organizations, does not adequately indicate whether or not an organization is in compliance with the laws relating to tax on unrelated business income. As a result, many organizations with unrelated business income may not report such income on their annual tax and information returns.

We believe the failure to comply usually is not the result of willful noncompliance but rather is a result of the exempt organization's failure to understand that a given activity constitutes an unrelated trade or business. Typically, an exempt organization will undertake an activity and will only file Form 990-T upon discovering that the activity constitutes an unrelated business. Unless the organization is large in scope and can afford the advice of legal or tax counsel prior to undertaking a new activity, the organization may not discover that the activity constitutes an unrelated business for several years after inception. This could result in a revenue loss to the Treasury.

To increase voluntary compliance in this area, Congress may wish to assist the Treasury in allocating its resources to ensure that exempt organizations are better educated as to the tax laws pertaining to unrelated business income. As a start, the Internal Revenue Publications, such as Internal Revenue Service Publication 598, Tax on Unrelated Business Income of Exempt Organizations, should be mailed to as many exempt organizations as the Treasury budget will permit.

In addition, information return Form 990 should be expanded to request sufficient information to alert the exempt organizations to the fact that a given activity might constitute an unrelated business. For example, Form 990 could contain questions which typically pertain to unrelated business, such as whether or not the organization has advertising receipts, whether or not the organization is involved in insurance activities, or whether or not the organization engages in unrelated for-profit ventures.

Greater voluntary compliance also could be achieved by an increase in the Treasury's allocation of resources to enforcement of the current laws pertaining to taxation of unrelated business income.

To the extent that Congress can assist the Treasury in allocating additional resources and top people to the exempt area, we believe that the level of voluntary compliance will be increased. To that end, the Internal Revenue Service recently announced its intention to conduct taxpayer compliance audits of 3,000 exempt organizations. We believe these audits are a strong start for increasing voluntary compliance. Nevertheless, since the Service has stated that the compliance audits will deal primarily with those organizations having unrelated business income, we are not convinced the audits will reach all organizations that may be failing to comply with the tax laws. In particular, those organizations with unrelated businesses that do not file Form 990-T and those exempt organizations that operate unrelated business in their for-profit subsidiaries are not likely to be audited. Further study as to the method for conducting more effective audits of these exempt organizations would be desirable.

Imposition of Different Standards of Compliance on Different Types of Exempt Organizations: The requirements for compliance with the laws relating to taxation of exempt organizations often are confusing and imprecise. For the large exempt organization that engages sophisticated tax and legal counsel, compliance will be achieved. However, for smaller organizations strict compliance is difficult and may be overlooked.

Lessening the standards of compliance for smaller exempt organizations would enable the Treasury to allocate more of its resources to those organizations which pay the vast majority of unrelated business income tax. In addition, more published revenue rulings might increase voluntary compliance by assisting those who are inexperienced in this area.

One way to achieve this result would be to increase the "specific deduction" for unrelated business taxable income. Under current law, an organization need pay unrelated business income tax only if its unrelated business income exceeds the $1,000 "specific deduction." If the specific deduction were increased to $5,000 or $10,000, small exempt organiations and those organizations with very little unrelated business income would not have to pay unrelated business income tax. The Treasury and Internal Revenue Service examiners in turn would be able to concentrate their efforts on more significant unrelated business income issues.

In addition, the penalties for failure to comply perhaps should differ for small and large exempt organizations. The penalty for failure to file a timely Form 990 can be as high as $5,000. Larger organizations, which can afford a $5,000 fine, are more likely to engage outside assistance in order to file on a timely basis. The smaller organizations are more likely to file late, but they usually cannot afford large penalties for failure to file a timely return. To alleviate this dichotomy, Congress may wish to consider reducing the penalties for late filing for those organizations with gross receipts less than $100,000.

The Association appreciates the opportunity to present these views and requests that this letter be included in the official record of the Subcommittee hearings.

Sincerely,

William E. Allen, D.D.S.
Director
Washington Office

STATEMENT
OF THE
AMERICAN DIABETES ASSOCIATION
ON THE
UNRELATED BUSINESS INCOME TAX (UBIT)

The American Diabetes Association (ADA) is pleased to submit its views to the Subcommittee on Oversight on the unrelated business income tax (UBIT). The ADA is the nation's leading voluntary health organization representing the interests of over 11 million Americans with diabetes.

ADA's mission is to find a preventive and cure for diabetes, and to improve the well-being of all people with diabetes and their families by providing information and support, and educating health professionals and the public about the seriousness of this chronic disease. ADA is the leading voluntary health organization supporting diabetes research and education in the United States and serves the entire diabetes community through the efforts of thousands of volunteers from more than 800 affiliates and local chapters in communities across the U.S., with over 225,000 members; we are a Section 501(c)(3) organization funded primarily through private contributions.

Diabetes with its complications -- including heart disease and kidney disease, as well as blindness and foot and leg disease -- is the third leading cause of death by disease in the United States, accounting for approximately 300,000 deaths annually. Diabetes represents a growing national financial burden as well, costing America $14 billion annually -- almost four percent of all health care expenditures. To meet the challenge of finding a preventive and cure for diabetes and improving the well-being of all people with diabetes and their families, the ADA has steadily grown from a small professional medical society to a multifaceted organization providing research, patient education, professional education, public education, and other community services. Over the past six years ADA's public membership and professional membership has doubled. Our budget in 1986 approached $36 million -- double our 1981 budget.

Despite our growth and our work, diabetes remains a serious national health concern, and to combat this public health problem the Association has mounted a comprehensive research, education, and support services campaign.

Research is an integral part of our search for a preventive and cure for diabetes, and last year the Association spent $6 million within the United States on immunology, biochemistry, cell metabolism and other kinds of research. Different components of our research initiative have helped young scientific investigators become independent researchers and enabled established researchers to pursue promising areas of opportunity. Further, for the third year the ADA administered the Lions Clubs International Research Program, which supported research in diabetic retinopathy, a degenerative eye disease and one of the most serious complications of diabetes.

Communication with millions of people with diabetes and their families and friends is essential to our mission, and our patient education initiatives provide 1) a broad range of person-to-person services conducted by ADA affiliates and chapters; and 2) an extensive national publishing enterprise, including Diabetes Forecast, published monthly and distributed to 225,000 ADA members, and Diabetes '87, which is distributed to over 600,000 people four times a year. Self-management and monitoring are critical components in the treatment of diabetes and these publications provide people with diabetes comprehensive information about how to manage their disease. ADA also provides an extensive array of services for young people, including summer camp programs sponsored by ADA affiliates, and has instituted a formal process to recognize quality patient education programs conducted by hospitals and community-based programs; any health care setting that provides a comprehensive diabetes patient education program is eligible for recognition if it meets a set of rigorous criteria.

The ADA keeps physicians and other health care practitioners abreast of the latest developments in diabetes care through our professional education programs. Our professional publications reach an audience of over 70,000 researchers, specialists, and primary care physicians, and our Scientific Sessions, held in conjunction with our Annual Meeting, provide over 3,000 professionals with the opportunity to communicate face-to-face on issues in diabetes research.

The ADA also has undertaken a comprehensive public education program, whereby volunteers in ADA chapters and affiliates conduct community education programs, keep federal, state and local representatives informed on issues of critical interest to people with diabetes, and develop public awareness campaigns to heighten public concern about diabetes.

All of these activities are made possible by a smooth-running, broad-based fund raising program, which last year raised $36.2 million through private contributions and corporate and foundation support.

In large part ADA's growth can be directly attributed to the commitment of our volunteers and membership, the growing public awareness of the seriousness of diabetes, and an aggressive fund raising campaign to meet the multiple goals and objectives of the Association.

Our growth can also be attributed to a number of other factors. For example, over the past six years cutbacks in federally-funded social welfare and human services programs have forced not-for-profit voluntary health associations to step in and help to fill the considerable gaps created by reduced federal commitments. However, recent modifications in the tax preferences extended to not-for-profit organizations -- specifically, in the Tax Reform Act of 1986 -- have placed an additional, and we believe unnecessary, financial burden on not-for-profits. These modifications have the potential to drastically impair the ability of not-for-profits to continue to offer a current level of services. Congress and the Administration have seemingly dispensed with the government's recognition of the unique public service roles not-for-profits play and have forced voluntary and not-for-profit organizations to become more effective in efforts to make up lost revenue. We recognize the fiscal and policy constraints presented by the federal budget deficit and the need to generate additional revenues to the Treasury. This has been one of the principal driving forces behind attempts in recent years by the Congress to modify tax preferences extended to deductions for nonitemizing taxpayers in th not-for-profit organizations. The removal of charitable contributions deductions for nonitemizing taxpayers in the Tax Reform Act of 1986 is an example of this. In 1985 over $25 billion was contributed to not-for-profit and voluntary agencies by nonitemizers. As a result of the Tax Reform Act, however, charitable giving is expected to decline precipitously, possibly by as much as $11 billion.

Additionally, the Tax Reform Act and recent IRS Rulings have mandated major retroactive increases in Federal tax and interest payments made under previously existing Industrial Revenue Bond contracts. A major effect of the reduction in corporate tax rates applicable to financial institutions, under the Tax Reform Act of 1986, is that, under previously tax exempt Industrial Revenue Bond obligations, payments by tax exempt organizations are increased by approximately 25% and profits retained by financial institutions are also increased by substantially larger amounts.

Modifications proposed by small business interests on the unrelated business income tax would serve to further restrict the ability of nonprofit and voluntary organizations to generate revenues needed to serve the constituencies they represent. Nonprofits have been granted tax preferences in recognition of the fact that the Federal Treasury is compensated for loss of revenues through the provision of services by nonprofits that afford financial relief from public appropriations, and by the social welfare and public benefits such organizations provide.

Reacting to concerns expressed by small business interests, Congress in 1950 enacted legislation imposing the unrelated business income tax. The Tax Reform Act of 1969 extended the UBIT to virtually all 501(c)(3) organizations. The current definitions stipulate that the UBIT applies to a commercial activity that involves the production of income from the sale of goods or services, is regularly carried on, and is not substantially related to the tax-exempt purposes of the organization. The central issue in application of the UBIT is the determination as to whether an activity is substantially related to an organization's tax-exempt purpose, but current tax law provides little clarification or guidance as to the definitions of "substantially related."

However, rather than limiting modifications of the UBIT to clearer definitions, improved guidance, or increased enforcement powers for the Internal Revenue Service, small business interests are proposing a wholesale, meataxe approach to solving this perceived problem, rather than attempting to improve or fine-tune the existing regulatory framework. The principal result of these modifications, if enacted, would be to unnecessarily restrict the ability of not-for-profits to generate revenues needed to provide important social welfare, health promotion, and other activities in the public interest. Much of the evidence cited by the small business community in support of restrictive modifications is anecdotal, and that evidence should not be employed as a basis for severely reducing the ability of legitimate not-for-profits to adapt to a changing economic environment -- an environment altered in no small measure by reduced federal support for human services and social welfare programs and by Congress' seeming retreat from recognition of the long-standing view that not-for-profits provide a unique public benefit.

RECOMMENDATIONS

We believe that the existing regulatory framework, with some modifications, is fully sufficient to address the concerns expressed by the small business community. Our recommendations are based on the assumptions that there is a definite need for more complete and accurate collection and dissemination of data on the UBIT and the tax-exempt community, and that the Internal Revenue Service should assume greater enforcement powers to ensure that unrelated business income is accurately reported and taxed accordingly.

1. The Internal Revenue Service should strictly enforce current UBIT regulations. The Commissioner of the Internal Revenue Service has stated that funding for enforcement of UBIT regulations will be held at maintenance levels and will not be increased. It is IRS' responsibility to ensure adequate enforcement of UBIT; not-for-profit organizations that abuse their tax-exempt status could be dealt with on a case-by-case basis in an effective manner if IRS' enforcement powers were increased.

2. The IRS should furnish more detailed and more accessible information to help tax-exempt organizations understand and comply with UBIT regulations. Revenue rulings, regulations, and official publications are either restricted or unavailable to not-for-profits and are therefore of little use in terms of providing guidance for compliance. Providing specific examples of where the UBIT applies and clearer and more precise definitions would greatly assist in not-for-profits' compliance.

3. Information from Forms 990 and 990-PF should be computerized and reported. There is nearly universal agreement that data collection, analysis, and dissemination on unrelated business activities of not-for-profits is virtually nonexistent. Computerizing the first page of Form 990 for tax-exempt organizations and Form 990-PF for private foundations will go a long-way in establishing a comprehensive database.

4. Establish a Task Force on Competition. Composed of members of the not-for-profit and for-profit communities as well as representatives from the IRS, to study the competition question and proposed modifications to the UBIT.

There is no question that not-for-profit and voluntary organizations play a critical role in our society -- especially in these times of budgetary cutbacks, restrictive tax policies, and growing demand for the services not-for-profits offer. Proposed modifications to the unrelated business income tax would serve to further increase administrative costs and constrict the flexibility of not-for-profits to provide essential services.

The American Diabetes Association contends that an excellent regulatory framework is already in place to correct abuse of UBIT regulations. We believe that as long as business-like activities are substantually related to an organization's tax-exempt purpose, not-for-profits should be permitted to engage in those activities.

STATEMENT OF ROBERT W. SPANOGLE, NATIONAL ADJUTANT

THE AMERICAN LEGION

Mr. Chairman and distinguished members of the Subcommittee on Oversight, The American Legion is pleased to present this statement for the record in response to the Subcommittee's request for background information on nonprofit tax-exempt organizations relative to the Unrelated Business Income Tax (UBIT). As you know, the Legion is a Congressionally chartered national tax-exempt organization under section 501 (c)(19) of the Internal Revenue Code and consists of 52 U.S. and 6 foreign Departments (state organizations) and more than 15,000 local Legion Posts around the world. For the purposes of this Subcommittee's comprehensive review of the Federal tax treatment of commercial and other income-producing activities of organizations that have tax exempt status under section 501 of the Internal Revenue Code, each Legion Department and Post is an independent taxable entity separate and apart from the National Office of The American Legion.

As might be expected in an organization with nearly 3,000,000 members, the types of income-producing activities, both active and passive, conducted by the Legion and its subelements are widely varied. For example, at the National level this organization's revenue is derived from a number of sources. While we will discuss these sources, we have included, as Appendix One, The American Legion National Headquarters Statement of Revenue, Expenses and Changes in fund balances, Current Fund which details the specifics of the Legion's revenue program. Virtually all of these revenues are specifically directed toward programs or similar initiatives that carry out the basic purposes of our organization.

The American Legion makes a public record of its finances in its "Annual Report to the United States Congress". The primary source of income ($14,532,021) for the National Headquarters of The American Legion comes from members' dues. The annual dues are set by the National Convention. Currently, the National Headquarters of The American Legion receives $5.50 from each member to operate business of the National Organization.

The second largest source of revenue for the National Headquarters of the Legion is from the sales of Emblem items. For the year ending December 31, 1985 the Legion's gross revenue on sales of Emblem merchandise totalled $5,018,952. These items which carry the seal of The American Legion are designed to create unity and esprit among our members as well as to increase the Legion's visibility. In our view, the sale of items with the Legion emblem is a non-competitive activity since, by Congressional charter, we have the exclusive right to our emblem and name. The Legion judiciously safeguards the use and reproduction of the words "The American Legion" and its emblem to insure that their use conforms to Legion guidelines. Because the Legion seal and name cannot legally be reproduced without the organization's permission, we believe that no competition exists between this revenue-generating activity and any for-profit business ventures.

The next largest source of income for the National Headquarters ($3,240,602) comes from advertising revenue generated through The American Legion Magazine. These revenues are, however, insufficient to offset the cost of publishing and distributing the magazine to each member. For example, in the year ending December 31, 1985 the cost of publishing and distributing the national magazine of The American Legion was $9,380,108. This means that ad revenues were $6,139,506 less than the cost of producing and distributing the magazine. For the same taxable year a total of $10,105.03 in UBIT was paid on ad revenues generated by the magazine.

At this point we would like to comment on the UBIT and its applications to advertising revenue of the Magazine. All advertisers, regardless of the medium used to make their presentations, do so for two reasons: 1) to acquire new clients, customers or members; or 2) to present and maintain their institutional and or public image. Advertisers carefully select the media which will reach their intended audience. The American Legion Magazine reaches a very specific audience with well known and defined demographics, the members of The American Legion and their families. This specific audience cannot be as a group reached through any other single advertising medium. Therefore, it can be argued that the Magazine does not directly compete with other advertising media and the application of the test of Unrelated Business Income Tax is inappropriate.

The Legion also has a significant amount of investment income derived from U.S. Government obligations and money market accounts. This investment portfolio has a market value of $28,526,122. For the convenience of the Subcommittee we have included, as Appendix Two, "Investments (Current Fund)" for the taxable years ending December 31, 1984 and December 31, 1985.

Lastly, the National Headquarters of The American Legion has revenues of $3,185,639 from several additional sources. The details of these revenues are contained in Appendix One. In this appendix you note the entry "Other restricted Income". This entry refers to receipts which are restricted by the donor. For example, the Legion is eligible to accept bequests and donations, subject to the approval of the National Executive Committee (NEC). In each case of a restricted bequest or donation the NEC must elect to accept the offer subject to the conditions set forth by the donor if it elects to accept them at all. Receipts which are restricted by the donor are credited to the appropriate restricted fund, against which all expenditures for the related project or program are charged. Periodically, the Legion may add to restricted funds through allocations from unappropriated funds for specific future purposes and projects. The use of Restricted Fund monies is designated by action of the National Finance Commission and the NEC. Earnings of the Fund, as well as principal, can be expended only on the recommendations of the National Finance Commission and a two-thirds affirmative vote of the NEC at two successive meetings. It is the policy of The American Legion to transfer 10 percent of the prior year's net income to the Restricted Fund. The effect of this, for 1985, is $275,825. The Reserve Fund, a designated fund, is also restricted as to use by the action of the National Finance Commission and the NEC. Earnings of the Fund may be used for the general operations of the Legion, but the principal can be expended only: 1) by action of the Legion at its National Convention; or 2) by two-thirds affirmative vote of the NEC in two successive meetings not less than sixty days apart.

The American Legion Endowment Fund Corporation (the Endowment Fund) was incorporated in 1925 as a not-for-profit corporation with perpetual existence to act as trustee for the American Legion Endowment Fund, which was created to provide rehabilitation of American veterans and assistance to orphans of veterans. In August, 1946 the Legion transferred securities having a market value of $2,001,000 to the Endowment Fund. The assets transferred have been held segregated by the Endowment Fund and the principal related to the 1946 transfer, which had a market value of $1,904,739 as of December 31, 1985, may be withdrawn by the Legion, if needed, for rehabilitation of veterans or assistance to orphans of veterans. Income earned on the investments of the Endowment Fund is payable to the Legion to support its programs for the above-mentioned purposes. Administrative expenses to operate the Fund are negligible since virtually all personnel and related costs are either donated or paid through General Fund expenditures for staff services. In addition to the amount received from the Endowment Fund of $615,096 in 1985, there was $157,826 on December 31, 1985 in net investment earnings of the Endowment Fund which was payable to the Legion. All Trust Fund operations are 501 (c)(3) or (6) nonprofit corporations. None of the principal or interest of the funds is used to pay administrative costs. Instead, all administrative costs are borne by the National Organization through the General Fund (see Appendix 1). As can be seen from this information, The American Legion does not go outside of its membership for donations and or fund-raising activities.

At the Department and Post levels fund-raising activities are more localized and more immediate. But here too the UBIT has had an impact on the revenue activities of these sub-units. Such revenue-generating programs might include the operation of a post-home, bingo, poppy sales, cake bakes, rental of their facilities to outside organizations, the sale of greeting cards and other fund-raising promotions.

In some cases, these activities are assessed by IRS as failing the relatedness test and are subject to UBIT. Because our Posts and Departments are so acutely aware of the problems posed by nonprofits competing with for-profit companies our legal officers at all levels (judge advocates) are regularly questioned regarding the propriety of conducting different types of fund raising ventures.

The National Headquarters of The American Legion does not have access to statistics on the UBIT paid by the Departments and Posts. However, if our readings of the requests for decisions are any indications of the amount of UBIT paid we would estimate that the figure is substantial.

The principal problem associated with this entire matter seems to stem from individual determinations of unfair competition by the Internal Revenue Service. Currently, the application of the UBIT test is unequal and seems to be based upon local or regional interpretations by IRS officials. It is this failure to maintain a standard that produces such confusion among our Departments and Posts when fund-raising efforts are being planned.

The difficulty in establishing UBIT liability seems to result largely from defining the term "regularly". Some IRS offices have interpreted "regular" to mean fund-raising events that are undertaken as infrequently as once a year. As an alternative, it would seem that at least a monthly frequency would be a more realistic determination of "regular".

Finally, as an organization that has fully complied with the law, The American Legion hopes that this subcommittee's examination of the issue will resolve the occasional uncertainties associated with how the law is applied.

APPENDIX ONE

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Statement of Revenue, Expenses and Changes in Fund Balances

Current Fund

	Year Ended 1985	
	Unappropriated	Appropriated Funds
REVENUE:		
National dues	$14,532,021	
Sales of Emblem items	5,018,962	
Advertising revenue	3,240,602	
Investment income	2,171,211	
Direct membership solicitation	973,772	
American Legion Endowment Fund Corporation income received	615,096	
Amounts withdrawn from The American Legion Life Insurance Trust	722,964	
Other restricted income	257,168	
Other income	616,649	
	28,148,425	
EXPENSES:		
Salaries	5,785,712	
Employee benefits	1,244,106	
Cost of sales	3,370,654	
Direct publication expenses	7,644,248	
Executive and staff travel	656,243	
Commission and committee	1,114,525	
Operational	2,773,606	
Office	2,342,962	
Occupancy	825,439	
Special projects and programs	1,122,796	
	26,880,291	
EXCESS OF REVENUE OVER EXPENSES	1,268,134	
FUND BALANCES, BEGINNING OF YEAR	8,653,131	$1,397,477
INTERFUND TRANSFERS	(439,119)	163,294
Adjustment to appropriated fund balance		(18,794)
FUND BALANCES, END OF YEAR	$ 9,482,146	$1,541,977

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Balance Sheet

	December 31	
	1985	1984
ASSETS		
CURRENT FUND:		
Cash	$ 1,216,781	$ 2,356,183
Accounts receivable:		
Emblem Division	74,253	75,884
Publications Division	348,864	284,477
Other	84,944	164,994
Accrued interest on investments	415,436	439,296
Inventories:		
Emblem Division	722,407	777,741
Publications Division	864,179	1,167,482
Prepaid expenses and supplies	213,028	182,908
Deferred direct membership solicitation expense	2,273,310	—
Deferred revenue enhancement expense	161,048	—
Postal deposits and other advances	55,413	31,102
	6,429,663	5,480,067
Investments		
Segregated for Designated Funds	9,067,578	8,110,385
Segregated for Washington, D.C. building	518,179	503,007
Other	18,099,472	16,887,061
	27,675,229	25,500,453
Property and equipment:		
Washington, D.C. real estate:		
Land	80,000	80,000
Building	1,204,432	815,183
Furniture, fixtures, and equipment in:		
National Headquarters building, Indianapolis, Indiana	1,493,108	1,349,304
Washington, D.C. building	316,308	309,715
Capitalized leases	535,497	499,362
	3,629,345	3,053,564
Deduct: Accumulated depreciation and amortization	2,112,530	1,934,310
	1,516,815	1,119,254
	35,621,707	32,099,774
NONEXPENDABLE FUNDS		
Overseas Graves Decoration Fund:		
Cash	11,323	40,713
Accrued interest on investments	8,579	7,360
Investments	584,230	509,462
	604,132	557,535
Paid-Up-For-Life Membership Fund:		
Cash	550	82,750
Accrued interest on investments	78,084	52,875
Investments	5,343,645	4,644,540
	5,422,279	4,780,165
	$41,648,118	$37,437,474

	December 31 1985	December 31 1984
LIABILITIES AND FUNDS		
CURRENT FUND:		
Liabilities:		
Accounts payable	$ 1.044.170	$ 999.798
Capitalized lease obligations	124,030	180.654
Deposits on Emblem merchandise sales	189,391	152.646
Funds in transit to The American Legion Life Insurance Trust	576,309	945.973
Deferred dues income	11,886,300	11,087,160
Deferred income—direct membership solicitation	983,134	—
Deferred revenue enhancement income	96,443	—
Accrued vacation benefits	316,240	299.228
Provision of health insurance liability	45,000	45.000
Other liabilities	84,952	37.970
Total liabilities	15,344,969	13.748.429
Fund balances		
Restricted funds:		
Oratorical Contest Fund	157,733	150.291
Other restricted funds	37,304	40.061
Designated funds:		
The Restricted Fund	6,889,312	5.954.266
The Reserve Fund	2,168,266	2.156.119
	9,252,615	8.300.737
Appropriated funds	1,541,977	1.397.477
Unappropriated	9,482,146	8.653.131
Total fund balance	20,276,738	18.351.345
	35,621,707	32,099.774
NONEXPENDABLE FUNDS		
Overseas Graves Decoration Fund:		
Fund Balance	604,132	557.535
	604,132	557,535
Paid-Up-For-Life Membership Fund:		
Fund balance	5,422,279	4.780.165
	5,422,279	4.780.165
	$41,648.118	$37.437.474

December 31		1984
Designated and Restricted Funds	**Total Current Fund**	**Total Current Fund**
	$14,532,021	$13,953,081
	5,018,952	4,676,588
	3,240,602	2,810,010
$ 671,368	2,842,579	2,683,163
	973,772	529,024
	615,096	580,612
109,000	831,954	1,183,637
24,387	281,565	246,389
	616,649	519,723
804,755	28,963,180	27,182,227
	5,785,712	5,564,895
	1,244,106	1,245,329
	3,370,654	2,786,561
	7,644,248	6,787,613
	656,243	609,588
	1,114,525	1,224,782
	2,773,606	1,753,206
	2,342,962	956,817
	825,439	752,032
128,702	1,251,498	2,270,966
128,702	27,008,993	23,951,789
676,053	1,944,187	3,230,438
8,300,737	18,351,345	15,161,508
275,825	—	—
	(18,794)	(40,601)
$9,252,615	$20,276,738	$18,351,345

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Statement of Revenue, Expenses and Changes in Fund Balances

Designated and Restricted Funds
Year Ended December 31, 1985

	Designated Funds	
	The Restricted Fund	The Reserve Fund
REVENUE:		
Investment income	$ 659,221	$ 12,147
Amounts withdrawn from The American Legion Life Insurance Trust		
Restricted contributions		
	659,221	12,147
EXPENSE:		
Special projects and programs		
EXCESS (DEFICIENCY) OF REVENUE OVER EXPENSES	659,221	12,147
FUND BALANCES, BEGINNING OF YEAR	5,954,266	2,156,119
INTERFUND TRANSFERS	275,825	
FUND BALANCES, END OF YEAR	$6,889,312	$2,168,266

Restricted Funds		
Oratorical Contest Fund	Other Restricted Funds	Total Designated And Restricted Funds
		$ 671,368
$109,000		109,000
	$24,387	24,387
109,000	24,387	804,755
101,558	27,144	128,702
7,442	(2,757)	676,053
150,291	40,061	8,300,737
		275,825
$157,733	$37,304	$9,252,615

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Notes to Financial Statements

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

General: The American Legion National Headquarters (the Legion) is a national veterans organization which was declared to be a corporate body by an Act of the United States Congress on September 16, 1919. The Legion acquired all of the assets and assumed all of the liabilities of the predecessor unincorporated national organization of the same name.

Basis of Presentation: The Legion generally reports for financial statement purposes on the accrual method of accounting, recognizing income when earned and expenses when incurred.

The Legion maintains its accounts on a fund accounting basis wherein the accountability for certain segments of its operations are presented in specific designated and restricted fund balances. Further, the Legion has designated certain amounts for future projects or purposes, which amounts are presented as appropriated funds in the accompanying financial statements.

The revenue and expenses of nonexpendable funds are not included in the Statement of Revenue, Expenses and Changes in Fund Balances—Current Fund. Instead, they are recorded directly to the nonexpendable funds involved as set forth in the footnotes to the financial statements.

The amounts shown for 1984 in the accompanying Statement of Revenue, Expenses and Changes in Fund Balances—Current Fund are included only to provide a basis for comparison with 1985 amounts.

Accounts Receivable: The direct charge-off method is used to account for losses in collection of accounts receivable. An allowance for uncollectible accounts receivable is considered unnecessary by the Legion because all significant accounts expected to be uncollectible have been written off.

Inventories: Inventories, which consist of Emblem items held for sale and magazine paper and publication rights, are valued at the lower of cost or market. Supplies which are not intended for sale are expensed when purchased.

Investments: Investments are recorded at cost. Premiums or discounts on investments are generally recognized at the time of disposal or maturity.

Property and Equipment: Furniture, fixtures and equipment are carried at cost and are depreciated beginning in the year after acquisition on the straight-line method based on the estimated useful lives of the assets involved. Leasehold improvements and repairs are expensed when incurred.

Depreciation on the Washington, D.C. building, which was constructed in 1951, is computed on the straight-line method using a fifty-year life. Beginning in 1969, investments approximately equal to the accumulated depreciation on the building have been segregated. Income on these investments is unrestricted.

Income: Dues are recognized as income in the applicable membership period which is on a calendar-year basis.

In addition to other methods of obtaining new members, the Legion uses direct mail and other direct marketing approaches. The income generated from the direct membership solicitation is recognized in the applicable membership period (calendar year) and the expenses incurred to obtain these memberships are deferred and written off in the period which the income is recognized.

During 1985, the Legion embarked on a campaign to increase revenues through the sale of posters, cards and calendars. The revenue and expense related to this program have been deferred and will be matched in the proper period and written off accordingly.

Income from The American Legion Endowment Fund Corporation and The American Legion Life Insurance Trust are recorded when received. These receipts are for projects and programs conducted in the year of receipt.

Pension Plan: The Legion has a defined-benefit pension plan covering substantially all of its employees, as well as those of certain affiliated and subordinated groups. The plan was established in 1944 by vote of the Legion's National Convention. Contributions to the plan are made by the Legion and other participating groups on the basis of annual actuarial valuations. The annual cost, as determined by the actuary, is computed using the aggregate-cost method and includes any past service costs.

Federal Income Tax: The Legion is exempt from federal income tax (except on unrelated business income) under Section 501 of the Internal Revenue Code.

APPENDIX TWO

INVESTMENTS (CURRENT FUND):

The cost and market value of Current Fund investments are as follows:

	December 31			
	1985		1984	
	Cost	Market Value	Cost	Market Value
Segregated for Designated Funds:				
U.S. Government obligations	$ 8,491,868	$ 9,123,413	$ 7,832,924	$ 8,093.383
Accrued interest—restricted	258,233	258,233	188,110	188,110
Money market accounts	280,000	280,000	—	—
Uninvested cash	27,477	27,477	89,351	89,351
	9,067,578	9,689,123	8,110,385	8,370,844
Segregated for Washington, D.C. building				
U.S. Government obligations	518,179	527,044	503,007	489.506
Other:				
U.S. Government obligations	18,099,472	18,309,955	16,687,061	16,946.581
Certificates of deposit	—	—	200,000	20,000
	18,099,472	18,309,955	16,887,061	17,146,581
Total investments	$27,675,229	$28,526,122	$25,500,453	$26,006,931

CAPITAL AND OPERATING LEASES:

The Legion has entered into lease agreements (which are accounted for as capital leases) for the rental of computer and copying equipment. The Legion has options to purchase the equipment or to extend the leases at the end of the original lease terms. The Legion is liable for property taxes, insurance, and repairs and maintenance in connection with the leased equipment. Cost and accumulated amortization of capitalized leases were $535,497 and $407,100 at December 31, 1985 and $499,362 and $299,700 at December 31, 1984. Future minimum payments on these leases, together with the present value of the payments, are as follows:

Years ending December 31:	
1986	$ 31,397
1987	31,397
1988	31,397
1989	31,397
1990	31,397
1991	31,397
Total future minimum payments	188,382
Less: Amount representing interest (approximately 13%)	64,352
Present value of future minimum payments ..	$124,030

The Legion also rents other computer equipment, copiers, and cash registers under operating leases. Total rental expense on these operating leases was approximately $110,000 in 1985 and $96,000 in 1984.

In addition, the Legion has a lease with the State of Indiana for rental of the National Headquarters building in Indianapolis through November, 1989. According to the terms of the lease, in lieu of rental payments the Legion is required to maintain the interior of the building, as well as provide adequate insurance on the building. The cost of maintenance and insurance approximated $291,000 in 1985 and $281,000 in 1984. The Legion has the option of renewing the lease on the same terms through November, 1993.

APPROPRIATED FUNDS AND INTERFUND TRANSFERS:

The balances of appropriated funds were as follows:

	December 31, 1984	Adjustment And Transfers	December 31, 1985
Publications Reserve	$ 397,939	$ (397,939)	$ —
Computer Reserve	—	500,000	500,000
Real Estate Reserve	841,977		841,977
Convention Reserve	100,000		100,000
Employee Insurance Premium Stabilization Reserve	57,561	42,439	100,000
Totals	$1,397,477	$ 144,500	$1,541,977

NONEXPENDABLE FUNDS

The earnings of the Overseas Graves Decoration Fund are being used to honor, preserve and decorate the graves of those who served in the United States armed forces who are buried overseas. The Fund is to continue at the will of the National Convention of the Legion or the National Executive Committee. The Fund's trust agreement may be amended, changed or succeeded at the will of the National Executive Committee, provided that the purpose for which the Fund was created is retained.

In October, 1974, the National Executive Committee approved the establishment of a life membership plan available to any member of a participating department. In accordance with the plan, the assets of the Paid-Up-For-Life Membership Fund are segregated in a trust account from which funds equal to the annual dues of life members are withdrawn for current operations each year. The trust agreement provides that the Legion has the right to withdraw part or all of the assets of the trust account and to modify or terminate the trust agreement at its discretion.

LIFE INSURANCE TRUST:

In connection with The American Legion's Life Insurance Plan, the Legion has created a Trust to which the First National Bank of Kansas City, Missouri, as Trustee, holds legal title. The accumulated earnings of the Trust funds and any experience rating refunds and dividends received from the insurors, which aggregate to approximately $5,566,000 as of December 31, 1985, are available for any of the following purposes, if approved by the Legion:

(a) To increase the Trust fund.

(b) To reduce or pay in full the life insurance premiums thereafter due from participants.

(c) To provide additional life insurance benefits for the participants.

(d) To make refunds to the participants.

(e) To make distributions to the Legion in support of its activities and programs serving the interest of the Legion and its members, provided that such distributions are not disapproved in writing by a majority of the participants.

In accordance with the provisions of item (e) above, the Legion's National Executive Committee has approved partial funding of the oratorical contest, Boys' Nation, American Legion Baseball, and other programs of the Legion. At December 31, 1985, $1,162,619 in Trust Funds had been approved for use in designated programs during 1986.

Changes in Nonexpendable Funds during the year ended December 31, 1985 are as follows:

	Overseas Graves Decoration Fund	Paid-Up For-Life Membership Fund
REVENUE:		
Paid-Up-For-Life membership dues collected		$ 642,676
Investment income	$ 60,129	540,459
	60,129	1,183,135
Expenses:		
Membership dues withdrawn		443,058
Decoration of graves:		
European Theatre	13,020	
Philippine Islands	500	
Administrative expense	12	83,069
Trust fees		14,893
	13,532	541,020
Excess of revenue over expenses	46,597	642,115
Fund balances, January 1, 1985	557,535	4,780,165
Fund balances, December 31, 1985	$604,132	$5,422,280

The cost and market value of investments in the Nonexpendable Funds are as follows:

	December 31			
	1985		1984	
	Cost	Market Value	Cost	Market Value
Overseas Graves Decoration Fund:				
U.S. Government obligations	$ 584,230	$ 610,287	$ 509,462	$ 513,960
Paid-Up-For-Life Membership Fund:				
U.S. Government obligations	$3,496,042	$3,712,742	$2,694,558	$2,750,294
Commercial paper	—	—	217,000	217,000
Money market accounts	941,182	941,182	1,110,694	1,110,694
Common stocks	907,421	1,202,619	622,288	702,038
Total investments	$5,343,645	$5,856,543	$4,644,540	$4,780,026

PENSION PLAN:

Pension expense under the defined-benefit pension plan in which the Legion participates was $533,643 in 1985. Accumulated plan benefit information, as estimated by the plan's actuary, and net assets of the plan allocable to The American Legion National Headquarters were as follows:

	January 1	
	1985	1984
Actuarial present value of accumulated plan benefits:		
Vested	$10,256,665	$ 9,480,679
Nonvested	885,154	1,029,383
Totals	$11,141,819	$10,510,062
Net assets available for plan benefits (at market value)	$12,729,126	$11,684,688

The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 6%.

Supplementary Information

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Analysis of Unappropriated Revenue And Expenses by Function

Year Ended December 31, 1985

	General		
	National Officers, Commissions And Committees	Internal Programs (primarily Indianapolis)	External Activities (primarily Washington, D.C.)
REVENUE:			
National dues		$ 7,267,282	$ 660,211
Sales of Emblem items			
Advertising revenue			
Investment income		2,171,211	
Direct membership solicitation		973,772	
American Legion Endowment Fund Corporation income received		184,529	430,567
Amounts withdrawn from American Legion Life Insurance Trust Fund		705,058	
Other restricted income		237,168	20,000
Other income	$ 5,000	223,977	28,928
	5,000	11,762,997	1,139,706
EXPENSES:			
Salaries	220,469	1,685,741	1,629,322
Employee benefits		1,244,106	
Cost of sales			
Direct publication expenses			
Executive and staff travel	311,696	173,638	99,814
Commission and committee	1,114,525		
Operational	7,417	2,375,696	76,793
Office	1,734	1,622,469	162,640
Occupancy		276,145	
Special projects and programs	47,009	(212,981)	406,061
	1,702,850	7,164,813	2,374,630
EXCESS OF REVENUE OVER EXPENSES	$(1,697,850)	$ 4,598,184	$(1,234,924)

Functions			Self-Supporting Functions		
Administration					
Indianapolis	Washington, D.C.	Total General Functions	Emblem Division	Publications Division	Total All Functions
		$ 7,927,493		$6,604,528	$14,532,021
			$5,018,952		5,018,952
				3,240,602	3,240,602
		2,171,211			2,171,211
		973,772			973,772
		615,096			615,096
$ 17,896		722,954			722,954
		257,168			257,168
91,180	$ 6,000	355,085		261,564	616,649
109,076	6,000	13,022,779	5,018,952	10,106,694	28,148,425
783,745	412,156	4,731,433	435,842	618,437	5,785,712
		1,244,106			1,244,106
35,648		35,648	3,043,542	291,464	3,370,654
				7,644,248	7,644,248
14,961	12,135	612,244	24,868	19,131	656,243
		1,114,525			1,114,525
44,107	29,483	2,533,496	200,657	39,454	2,773,606
67,493	66,332	1,920,668	236,652	185,642	2,342,962
286,839	187,361	750,345	16,545	58,549	825,439
(146,836)	146,233	238,386	361,228	523,182	1,122,796
1,085,857	852,700	13,180,850	4,319,334	9,380,107	26,880,291
$(976,781)	$(846,700)	$(158,071)	$ 699,618	$ 726,587	$ 1,268,134

THE AMERICAN LEGION NATIONAL HEADQUARTERS

Reconciliation of Audited Financial Statements to Internal Financial Statements Year Ended December 31, 1985

	Total Current Fund
EXCESS OF REVENUE OVER EXPENSES— INTERNAL FINANCIAL STATEMENTS:	
Page 1	$1,268,134
ADD:	
Excess of revenue over expenses for certain designated and restricted funds not included in internal financials—principally The Restricted Fund	676,053
EXCESS OF REVENUE OVER EXPENSES— AUDITED FINANCIAL STATEMENTS—	$1,944,187

American Legion Endowment Fund Corporation

Forseeing the necessity of a recurring income source for fuding its war veterans rehabilitation and child welfare programs, The American Legion conducted a national campaign in 1925 which raised approximately $5 million for this purpose. The funds contributed were entrusted to the custody of the American Legion Endowment Fund Corporation.

The Corporation was incorporated under the laws of the State of Delaware in 1925 and a trust agreement between The American Legion and the Corporation was signed in accordance with which the funds are administered by the Corporation with the annual net investment income being paid to The American Legion for use in the two programs involved.

The operations and financial condition of the American Legion Endowment Fund Corporation for each of the last five years are summarized below (taken from the annual audit reports prepared by Geo. S. Olive & Co., Indianapolis, Indiana).

	December 31 1985	December 31 1984	December 31 1983	December 31 1982	December 31 1981
Total assets	$7,351,453	$7,340,044	$7,314,933	$7,310,964	$7,316,357
Investments—at cost	$7,260,235	$7,250,912	$7,243,536	$7,221,538	$7.120.407
Interest income	$ 639,808	$ 626,405	$ 616,218	$ 639.065	$ 629.892
Expenses	31,237	27,469	23,225	20.920	25.712
Excess income over expense	$ 608,571	$ 598.936	$ 592.993	$ 618.145	$ 604.180
Funds transferred to The American Legion	$ 615.096	$ 580.612	$ 585.690	$ 606.384	$ 602.350
Average yield on book value of investments	8.90%	8.92%	8.80%	8.85%	8.73%

STATEMENT

of the

AMERICAN MEDICAL ASSOCIATION

to the

Oversight Subcommittee
Committee on Ways and Means
U.S. House of Representatives

RE: Unrelated Business Income Tax

July 22, 1987

The American Medical Association (the "AMA") is a professional association comprised of approximately 250,000 practicing physicians, academics, residents, interns and medical students. As such, the AMA is generally exempt from tax under section 501(c)(6) of the Internal Revenue Code of 1986 ("Code") but is subject to tax on its unrelated business taxable income as defined in section 512 of the Code. We are pleased to provide this statement to the Subcommittee to be a part of the record of the Subcommittee's examination of the unrelated business income tax provisions of the Code.

The AMA believes that the long-standing practice of granting tax exemption to not-for-profit organizations whose activities benefit the public has served its purposes well. Further, the AMA feels that such organizations should be taxed on net income derived from the conduct of businesses which are unrelated to the purposes for which the organizations are granted tax exemptions. We have reservations about whether such a tax is necessary to prevent unfair competition with commercial firms, but we believe that such a tax is advisable so that the overall system will be perceived as being even-handed.

The principal objective of the unrelated business tax is to tax the net income from business activities in the same manner regardless of whether the businesses are carried on by exempt organizations or by nonexempt, commercial enterprises. The legislative history of the 1950 statute enacting the unrelated business income tax indicates that:

> [B]oth [Senate and House] provisions merely impose [upon exempt organizations] the same tax on income from an unrelated trade or business as is borne by their competitors. (S. Rept. No. 2375. 81st Cong., 2d Sess. 28 (1950) (emphasis supplied).)

The Treasury Regulations similarly state:

> The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. (Treas. Reg. § 1.513(b) (emphasis supplied).)

It is thus essential to attainment of this objective that unrelated businesses conducted by exempt organizations be subject to the same tax burden, no more and no less, than that imposed upon commercial firms. Much of the testimony presented to this Subcommittee contends that exempt organizations are not shouldering their share of the burden either because the Internal Revenue Service is unable to enforce the law or because exempt organizations have been able to sidestep its application. In at least one significant area, however, the Treasury Department and the Service have for many years sought to impose a greater tax burden on exempt organizations than is imposed on their commercial competitors.

This has spawned controversies with the Service and is currently the subject of several pending court cases. That area is taxation of advertising income from periodicals published by exempt organizations. Because representatives of commercial publishers have misstated the issues in testimony before this Subcommittee, the AMA feels obligated to clarify the record.

1. The AMA believes that the Treasury Regulations as implemented by the Service seriously overstate the net income from advertising in periodicals published by exempt membership organizations. In brief, the Regulations require exempt organizations to allocate membership dues to such periodicals as, in effect, subscription income and as a result the tax deductions allowable in computing taxable advertising income are greatly reduced. This allocation of hypothetical subscription income is wholly arbitrary. No objective standard is used to ascertain what, if anything, members are actually paying for these periodicals when they pay their dues. The Service believes an allocation is required under the Regulations even though the member whose dues are being allocated would receive the periodical free of charge even if he or she were not a member. Distribution of periodicals free of charge to readers who are the advertisers' target audience ensures coverage of the audience and increases advertising revenues. The practice is called "controlled circulation." Virtually every commercially published periodical directed to the medical profession employs controlled circulation distribution for substantially all of its circulation.

2. Independent analysis has confirmed that the Treasury Regulations as applied by the Service imply profit margins for periodicals published by exempt organizations that are many times greater than those realized by nonexempt publishers. In connection with its prosecution of a tax refund suit in the United States District Court for the Northern District of Illinois, the AMA submitted a study showing that the Service's construction of the Regulations resulted in profit margins up to ten times larger than those earned by for profit publishers.

3. The suggestion made by representatives of commercial publishers that exempt organizations should be taxed on subscription income including imputed subscription income from arbitrary allocations of dues would not only make an already serious problem worse, it would for the first time tax an exempt organization for carrying out its exempt purposes. The "subscription income" resulting from mandatory allocations of dues is at best hypothetical income. Requiring that such hypothetical income be used to offset otherwise deductible costs is misguided. To tax such income itself would be seriously wrong. Such a tax would reverse the long-standing principle that receipts from activities that accomplish an organization's exempt purposes are not taxable. To be taxable a business must be unrelated to those exempt purposes. In the end the suggestion that receipts from "related" activities should be taxed leads to an overall denial of the tax exemption for such receipts. There is no logical stopping point between that suggestion and denial of tax exemptions generally. This would be a radical and undesirable departure from a policy that is decades old.

AMA's Comments on Observations and Recommendations of the Treasury Department

Deputy Assistant Treasury Secretary O. Donaldson Chapoton, in his statement on behalf of the Treasury Department to this Subcommittee on June 22, 1987, presented seven "initial observations and recommendations" which Treasury has regarding the unrelated business income tax. Mr. Chapoton stated:

> [T]he primary purpose of my testimony today is to identify issues deserving further attention and to examine the relevant tax policy considerations. Although my testimony contains several recommendations and suggestions, these are intended not as specific legislative proposals, but as a starting point for further debate.

As to the seven initial observations and recommendations contained in his statement, Mr. Chapoton emphasized "the need for additional information before specific proposals can be put forward."

This Subcommittee has requested that persons submitting statements comment on those observations and recommendations. The AMA's comments are as follows.

1. The "Substantially Related" Test

The AMA agrees that the current standard of a substantial relationship to the organization's exempt purposes has conceptual merit for granting exemption from tax of an exempt organization's income from business activities and should be retained. As a practical matter, the "substantially related" test is a necessary corollary to the basic tax exemption. Costs of activities that further an organization's exempt purposes might be funded through contributions and dues or through charges for the activities themselves. It would not be appropriate to tax the revenue derived from charges for activities that further an organization's exempt purpose.

The AMA also agrees that more detailed reporting by exempt organizations is desirable as a mean of improving enforcement and compliance and of providing a basis for further review of the adequacy of the standard.

2. Exceptions to the Definition of an Unrelated Business

The AMA has not formulated an opinion on the propriety of exempting from tax the income of businesses operated by volunteers or for the convenience of students, patients and others.

3. Computation of Unrelated Business Taxable Income

A. Allocation of Expenses

The AMA believes that the decision of the Second Circuit in Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984), was based upon the facts of that case and once the factual issue was resolved in favor of the taxpayer, the result was dictated by the applicable Treasury Regulation, section 1.512(a)-1(c). Because allocation issues are resolved only with reference to the facts of each case, the AMA believes that Treasury's request that Congress provide clarification in this area is misplaced. Congress should provide broad rules of general application. It is the role of Treasury and of the courts to apply those rules to specific factual cases.

The Treasury's other suggestion regarding the allocations rules, that the allocation of expenses should not be permitted to exceed the fair market value of the facility used or the goods or services received, while perhaps laudable as an attempt to prevent possible abuse of the allocation rules, would open a Pandora's box of administrative difficulties. The exempt organization and ultimately the Internal Revenue Service's field personnel would be required to expend considerable resources in attempting to establish the fair market value of facilities and goods and services. In many cases, such as a university fieldhouse, there may be no comparable commercial facilities available for measuring fair market value. A continuing theme of the testimony before this Subcommittee has been the need to reduce the complexity of administering the unrelated business income tax. This suggestion runs counter to that theme.

B. The Specific Deduction

If the purpose of the specific deduction is to free organizations with only a small amount of profit from the obligation to file Form 990-T and to pay the tax, the AMA praises the Treasury suggestion to raise the specific deduction to $5,000. A specific deduction of $5,000 would have an insignificant impact on the AMA's unrelated business income tax liability. The AMA has no objection to a phaseout of the specific deduction for organizations with a substantial amount of unrelated business taxable income.

C. The Fragmentation Rule

The AMA believes that the fragmentation rule is necessary to enforce the intended limits of tax exemption. Although the Internal Revenue Service may experience administrative difficulties in applying the fragmentation rule in some contexts, such as retail businesses, no such difficulties are present in applying the fragmentation rule to identify the AMA's taxable advertising component of its publishing activities.

4. Unrelated Businesses Carried on by Subsidiaries

Treasury raises a valid concern regarding the definition of "control" in determining whether interest, annuities, rents and royalties received by an exempt parent from its controlled subsidiary constitute gross income subject to the unrelated business income tax by application of section 512(b)(13) of the Code. Section 512(b)(13) prevents an exempt organization from reducing its unrelated business taxable income through the device of creating a commercial subsidiary which makes payments to the exempt parent which are deductible to the subsidiary and, but for section 512(b)(13), would not be taxable income to the parent. The rationale behind section 512(b)(13) is that if income generated by an unrelated business activity remains in a single economic unit consisting of the exempt parent and its taxable subsidiary, the passive income exceptions to the unrelated business income tax should not provide a basis for reducing the taxable income of the unit. The definition of the economic unit in current law is drawn by reference to section 368(c). Under that definition, the parent must own 80% of the shares of each class of nonvoting stock. This is a very rigid test which has proven easy to avoid in practice without breaking the unity of the parent and the subsidiary. The Treasury's suggestion for relaxation of the "control" definition is reasonable in light of the purpose of section 512(c)(13).

On the other hand, the notion that the primary purpose of an exempt organization should be tested by reference to that organization and its subsidiaries is not necessary to avoid schemes aimed at sidestepping the purposes of the exempt organization provisions of the Code. Exempt organizations may hold investments in commercial firms without affecting their exempt status. The degree of ownership should not affect this conclusion. However, if the parent organization devotes its own time and resources to the activities of its affiliates, those actions should be, and under current law are, taken into account in determining the parent's purpose.

5. Passive Income

Treasury's discussion of the tax treatment of passive income -- dividends, interest, annuities, royalties and rents -- suggests different treatment of such income depending upon the nature of the recipient. Treasury proposes to retain the exemption from tax for passive income of organizations exempt under section 501(c)(3), such as public charities. On the other hand, Treasury proposes to tax passive income of social welfare organizations exempt under section 501(c)(4). Treasury raises the possibility of taxing passive income of labor unions (exempt under section 501(c)(5)) and trade associations (exempt under section 501(c)(6)), but states that this issue requires further study.

Treasury's concerns regarding the exemption for investment income of labor unions and trade associations are that the exemption may have the effect of granting a current deduction for future expenses and may in some cases effectively provide a deduction for expenses which would not be deductible if paid by the members directly.

Similar concerns could be raised regarding capital expenditures made by exempt organizations with currently deductible dues, or regarding currently deductible contributions to charitable organizations which are not expended by the charities until later years. Any attempt to correlate the timing of the deductibility of dues or contributions with the timing of expenditures by the organizations probably would have the effect of eliminating the organizations' general exemption from tax; it certainly would be unworkable.

Treasury fails to recognize that labor unions and trade associations can not always match their dues receipts with their expenditures. Such organizations, like charitable organizations, require working capital to carry out their exempt purposes. They should te treated no differently than charitable organizations with respect to investment income.

6. Research Activities

The AMA agrees with Treasury that there is a need to identify those types of research activities which should be encouraged with tax exemption and that the public should benefit from any tax-exempt research. The AMA has not formulated any views as to what standards are appropriate to distinguish exempt from non-exempt research.

7. Joint Ventures

As pointed out in the Treasury statement, recent legislative enactments have drastically reduced the opportunities to shift tax deductions from tax-exempt to taxable partners. The Treasury statement identifies the partnership allocation rules only as having "the potential for abuse." Treasury has demonstrated on countless occasions the ability to reign in abusive tax avoidance techniques. The AMA believes that Treasury will be able to identify and close down any abuses in this area if they occur. Congressional involvement in this area is not required at this time.

Conclusion

The AMA believes that the long-standing practice of granting tax exemptions to not-for-profit organizations whose activities benefit the public has served its purposes well. Further, the AMA believes that such organizations should be taxed on net income derived from the conduct of businesses which are unrelated to the purposes for which the organizations are granted tax exemptions. Exempt organizations should be subject to the same tax burden, no more and no less, than that imposed upon commercial firms.

3119p.

STATEMENT OF THE AMERICAN SOCIETY FOR PERSONNEL ADMINISTRATION

The American Society for Personnel Administration is the world's largest professional human resource management association with a membership of 35,000 individuals. There are no corporate or organizational members. Our membership represents organizations collectively employing over forty million people in the United States. The Society is deeply committed to encouraging excellence in all aspects of human resource management for both private and public sector employees. We are a tax-exempt organization under section 501(c)6 of the Internal Revenue Code.

The American Society for Personnel Administration applauds the efforts of the Ways and Means Committee, through this Oversight Subcommittee, to ensure that the existing statutory requirements of the unrelated business income tax (UBIT) statute are being met by tax-exempt organizations and are being properly administered by the Internal Revenue Service.

The Society supports strict enforcement by the IRS of existing UBIT rules. Any abuse of the tax-exempt status by nonprofit organizations should not be tolerated and should be dealt with appropriately. It is our hope that through this Subcommittee's thorough review of both the unrelated business income tax and the level of current enforcement of UBIT rules, understanding of what the rules require and how to ensure compliance will be greatly enhanced.

ASPA believes that a great many instances of UBIT non-compliance almost certainly arise from confusion or uncertainty about what is required under law, rather than a specific desire by any organization to circumvent the rules. Recent court decisions have not helped in clarifying the issue of how to define what qualifies as unrelated business taxable income. Even IRS officials who must make the determination of whether income is unrelated to an association's tax-exempt purpose, acknowledge that it can be very difficult to know when to apply the unrelated business income tax. Interpretation of the "relatedness" test is the source of these difficulties. When vagueness of UBIT requirements is acknowledged by the IRS, it is not surprising that nonprofits have trouble themselves in deciding when income may be deemed "related" or "unrelated."

We do not question the legal disposition of recent UBIT cases or the IRS application of the existing UBIT statute in order to excuse abuses of tax-exempt status, but to assist the subcommittee in comprehending the atmosphere of uncertainty in which tax-exempt organizations are operating when it comes to the UBIT.

Current law requires associations to pay tax on the net gain from activities that are unrelated to its exempt purpose. The statutory definition of unrelated business income is income from any unrelated trade or business regularly conducted by an exempt organization. Concrete guidelines for determining when an activity is in fact unrelated do not exist and authorities have no particular set of rules upon which they rely when making their own determination.

There is an acute lack of hard data available to associations and other nonprofits (as well as to the IRS) that can be used to formulate guidelines in determining whether activities and income are unrelated to the exempt purpose. The Society believes that cooperation between the IRS and the community of nontaxable organizations will help achieve mutual understanding of 1) how IRS interprets the UBIT and 2) why nonprofits have such difficulty in determining unrelatedness.

ASPA supports retaining the UBIT statute as currently written but also strongly encourages a series of actions intended to expand general understanding on how the UBIT statute will be interpreted and how nonprofits can determine for themselves what activities will be judged as unrelated to the exempt purpose.

We strongly encourage a greater exchange of information between the IRS and tax-exempt groups in order to avoid confusion and the filing of incorrect returns by associations and other tax-exempt groups. Nonprofits need to inform the IRS about their income-producing activities and the IRS should communicate to tax-exempt organizations what standards or guidelines are being followed in determining unrelated business income. Tax-exempts should continue working with the IRS on the revision of the tax forms 990 and 990-T, which must be completed annually by all nonprofits. A long term information gathering effort should be jointly undertaken by the IRS and representatives of tax-exempt organizations. A key focus of the effort should be sources of income for nonprofits and the size of the nonprofit sector relative to taxable businesses.

As to the issue of unfair competition, raised by a number of small businesses in the taxable sector, it is important to remember that taxable businesses have a number of options available to them for the purpose of raising capital. These same options are not available to nonprofits, whose chief sources of income are membership dues, contributions and passive investments. There exists a very definite trade-off for operating as a nonprofit.

The UBIT was initially enacted in 1950 in response to complaints from the taxable business sector about unfair competition. That such complaints persist does not mean that the law requires revision but rather that greater focus upon enforcement and uniform application is warranted. Taxable businesses claim they want only a level playing field because they believe nonprofits are conducting commercial activities that compete with their own for profit activities; and the tax-exempt status provides a type of windfall for nonprofits.

In response to this "unfair advantage" argument, we believe that it is without merit since taxable businesses may raise capital through a number of activities that are appropriately unavailable to nonprofits. This advantage for taxable business works to "level" the playing field. There is no unfair competition, only competition, and there is certainly nothing intrinsically wrong with that.

In conclusion, the American Society for Personnel Administration urges the Subcommittee to recommend retaining the existing unrelated business income tax law and concentrating instead upon encouraging greater communication between the IRS and the nonprofit community. The goal of this communication should be to ensure that all parties involved are operating with the same set of guidelines and interpretations as to unrelated business income determination.

APPLIED RESEARCH ASSOCIATES
15312 Spencerville Court
Burtonsville, Maryland 20866
(301) 384-0800

Paul O. Davis, Ph.D., FACSM
President

Charles O. Dotson, Ph.D.
Vice President

31 July 1987

Robert J. Leonard,
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
Room 1102
Longworth House Office Building,
Washington, D.C. 20515

Re: Testimony on the issue of un-related income for
tax-exempt institution

Dear Mr. Leonard:

In response to requests for statements,

Eleven years ago, upon completing my graduate training at the University, I was thrust into the job market- not unwillingly, but rather, eager to pursue a career for which I had been trained. For six years, been a graduate student, earning a Master's Degree at American University and a Ph.D. at the University of Maryland.

Our fledgling firm struggled to create a nitch in the area of government contracting, exploiting a unique set of capabilities in the development and design of physical fitness programs.

Not long after starting this business, we were approached by the faculty of the American University, for the purpose of cooperating with a market survey project. Students would, under the guise of a graduate program, develop a comprehensive overview of company and the intended market. We were provided a copy of the very excellent document, and thanked the graduate students for their assistance.

Shortly after this event, the American University entered the market place, selling the same type of services; a rather unique departure from their rather traditional role of providing education. To add to the quandry, government contracts were given to the University on a sole source for reasons that were never determined.

We began to run into other University's who entered the realm of government contracting; heretofore, never seen. Specifically, the University of Maryland, George Mason University and George Washington University were agressively selling their services.

We have good reason to believe that these educational institutions clearly enjoy a competitive edge in view of the fact that graduate students are being used to staff these operations, in some cases without pay as interns. On the other hand, we are trying to hold our own with graduates of these same universities, who are paid reasonable and competitive salaries comensurate with experience.

Competition is good for the industry. But when some of the players can play under a different set of rules, it's no longer competition. I never thought that my major competion would be my alma mater.

I hope that this information is of value. If there is any additional information that I can supply, please feel free to call me at the number above.

Thank you for your interest and attention to this matter.

Sincerely,

Paul O. Davis, Ph.D.

cc: Connie Morello

ARIZONA
HEARING
AID
SOCIETY

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July 2, 1987

Representive J.J. Pickle
House of Representatives
Washington, D.C.

Subject: University Competition with Free-Enterprise

Dear Representative Pickle,

I have just received a copy of an article printed in the Phoenix Gazette, Saturday June 27, 1987. (Copy enclosed) This article states that Arizona Board of Regents member Jack Pfister in testimony before your committee said, in part "...the most controversial Arizona case (State Competition With Free Enterprise) challenged a University of Arizona Medical School practice of supplying recycled hearing aids to indigents."

Since none of us are infalable it is possible that Mr. Pfister was misquoted. But, if the quote is accurate then Mr. Pfister would seem to either be unaware of the activities he is suppose to be overseeing, or he has intentionally tried to mislead your committee. I feel I can say this, since I am the representative of the Arizona Hearing Aid Society who has been charged with the responsibility of challenging the hearing aid sales practices of the University of Arizona.

On June 11, 1987 I sent to your committee the text of my oral statement before the Arizona State Free Enterprise Review Board. That board found the University of Arizona and the Board of Regents guilty of improper free enterprise competition, in that they are selling hearing aids to the non-indigent general public. The board decision was unanimous. With this decision the board recommended that the State legislature enact legislation to prohibit this specific activity by any of the state universities.

This society has never challenged the provision of recycled hearing instruments to indigent persons. And, to our knowledge no one else is this state has even challenged this practice Mr. Pfister's comments not withstanding.

With the statement quoted above it would seem that Mr Phister has initiated a dis-information campaign to mislead your committee and the general public about problems the free enterprise system has with the universities in this state. In my opinion our government would be better served by his advocating adherance to the finding of the State Free Enterprise Review Board rather than trying to mistate the facts.

I would be happy to provide you with further information if you should so desire.

Sincerely,

K. Ray Katz, B.C.-H.I.S,
Director

enclosure

cc Gov. E. Meacham
Sen. D. Deconcini
Sen. J. McCain
Rep. J. Rhodes
Rep. M Udall
Rep. B. Stump
Rep. J. Kyl
Rep. J. Kolbe
L. Lovell
R. Kidder
D. West
J. Pfister

THE PHOENIX GAZETTE - Saturday, June 27,

Regent backs exempt status of universities

By Sean Griffin
The Phoenix Gazette

WASHINGTON — Arizona regent Jack Pfister urged a Ways and Means subcommittee Friday to avoid tinkering with the tax-exempt status of collegiate activities — at least until research proves there is a problem.

Pfister

The hearing, called to determine whether tax-exempt institutions like colleges and universities unfairly compete with private enterprise, Pfister said, "No new federal legislation is required in this area."

Pfister, general manager of Salt River Project, said a 6-year-old Arizona law barring competition between the state's educational institutions and private enterprise had demonstrated that public entities had not infringed on the private sector.

Pfister said the most controversial Arizona case challenged a University of Arizona Medical School practice of supplying recycled hearing aids to the indigent. Pfister said educators considered the practice a related educational activity because it gave medical students an opportunity to diagnose and treat hearing problems.

"The trend of universities is to be more entrepreneurial," Pfister said.

He said basic research — the traditional domain of universities — is being supplemented by applied research, as in the case of artificial hearts.

"I think there is a trend — certainly in Arizona but I suspect nationally — that will cause kindling friction on this issue of competition."

Pfister suggested the issue be handled by allowing professors to profit directly from the results of their research. Since their income would be subject to federal income tax, Pfister said the issue of public-private competition would be moot.

The hearing was called by subcommittee chairman J.J. Pickle, D-Texas, who has indicated an interest in taxing profitable activities — such as textbook sales and dormitory housing — of educational institutions and other non-profit organizations.

AUDIO HEARING AID CENTER, Inc.

3915 W. STATE STREET
BOISE; IDAHO 83703 • PHONE: 208/345-1612

LAWRENCE J. HOUSE
Certified Hearing Aid Audiologist
Board Certified NBC-HIS

July 10, 1987

Re: Unfair Competition
From Nonprofit Entities

Dear Chief Counsel Robert J. Leonard:

Definition of the Problem

1. Competition between commercial for-profit firms and tax-exempt organizations is increasing. Markets traditionally served by small, for-profit firms are now being offered products and services produced by tax-exempt, not-for-profit entities.

2. While the public perception of tax-exempt organizations is that they derive most of their income from charitable contributions and tax revenues, according to reports filed with the Internal Revenue Service, they derive 76 percent of their income from sales. In contrast, their gifts and dues income represents only 23 percent of their income. Of course, some of the sales may be charges for such things as publications, that are clearly part of the nonprofit's charitable, educational or cultural mission serving the needy, and the sick and disabled or association members. However, the competition posed by many of these sales activities is unfair and should be dealt with.

As of December 1, 1986, the Elk's Rehabilitation Hospital, at 204 Fort Place in Boise, Idaho, is actively dispensing hearing aids under their tax exempt non-profit status.

Products and services which are offered by this non-profit hospital are in direct competition with products and services provided by us, the small for-profit businesses, thus the basis for our claim of unfair competition.

The Unfair Aspects

1. The non-profit (currently the Elk's Hospital) pay no federal, state or local taxes on profits generated from sales of products and hearing aid related services.
2. The non-profit entity is able to use non-profit mailing rates in its sales promotion efforts.
3. The non-profit entity is exempt from normal taxes borne by most of us, such as the sales tax, inventory tax, corporate and property tax.
4. The hearing aid department of the Elk's Hospital may operate while using rent-free facilities and the workforce is paid in part or in whole by public or hospital funds.

I, therefore, respectfully request your consideration of our dilemma.

We would suggest either denial of the non-profit tax status to those entities which compete with the for-profit businesses or prohibition of the competing activities.

I would greatly appreciate your response concerning these matters.

Sincerely,

L J House

Lawrence J. House

Audio Prosthetics

"INSTRUMENTS FOR BETTER HEARING"
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911 W. HENDERSON STREET, SALISBURY, N. C. 28144

(ACROSS FROM ROWAN MEMORIAL HOSPITAL)
PHONE 704-633-5721

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- *SWIMMERS MOLDS
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AUDIOMETRIC HEARING TESTS

HEARING AID EVALUATION

RENTAL–PURCHASE PLANS

DR. REFERRALS WELCOME

WE SUBSCRIBE TO AND SUPPORT MANY PROFESSIONAL ORGANIZATIONS THAT FUNCTION TO PROMOTE BETTER HEARING.

July 16, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means, U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D. C. 20515

Mr. Leonard:

Small, family operated businesses in the free enterprise system have proven their value in the national economy.

We own a hearing aid service and have paid our share of taxes through the years---never required any subsidy of any sort to stay in business.

Honest, fair competition never bothered us. However, we object to competition from institutions that are chartered as "non profit". This gives them an unfair advantage in the market place.

Unfair competition is creeping into many segments of marketing, and can only damage our economy and the free enterprise system. There are (4) so called "non profit" facilities within my service area who are dispensing hearing aids.

It is a known fact that hospitals and clinics are advertising for patients. That's O.K., but if they are to have tax exempt status and dispense prosthetic devices---then we should have the same benefit.

Action should be taken to correct this.

Sincerely,

Samuel I. Kiser
Aurologist

SK/mk

"FACTORY REPAIR ON ANY MAKE OF AID"

AUDIOLOGIC SERVICES

ALBERT SILVERIO, M.A., CCC-A
Audiologist

LINDA LONERGAN
Receptionist

6-16-87

re: commercial activities of
tax-exempt businesses

Mr. Leonard:

I'm in west central Illinois far out in a rural area and I have a major competitor nearby who enjoys tax-exempt status and a less-frequently-heard-from competitor a bit farther away with the same advantage. Directly or indirectly my tax dollars support both of these competitors, and the major competitor (a hospital) receives charitable support as well. This problem is to be found all across our country.

A diversity of small businesses is a driving force in local economies, but the number and health of such businesses can be seriously affected by the presence of tax-exempt competitors. The operators of small businesses thus may suffer first as tax-exempt competitors drive them down, but in time, citizens in general suffer from lack of choice in service sources and a less robust local economy.

I used to work in a large hospital...the financial accounting practices in such businesses can become quite creative and imaginative. To argue that different kinds of business activity can be kept separate is a joke and an insult to intelligence when such situations are involved. Thus I argue that tax-exempt status should be available only to organizations that are truly non-profit and which do not threaten the existence of local small businesses which directly or indirectly by their very presence support the continued existence of the tax-supported organization.

Yours truly,

A. Silverio

Albert P. Silverio, M.A.
Audiologist

238 West State Street
Jacksonville, Illinois 62650
Telephone (217) 243-5121

Office Hours:
Monday thru Friday 9-5
Saturday 9-12

STATEMENT OF THE BANKERS COMMITTEE FOR TAX EQUALITY

Mr. Chairman, members of the Ways and Means Subcommittee on Oversight, we appreciate the opportunity to provide this statement on non-profit competition with taxable businesses. Our group, the Bankers Committee, is concerned about competition with credit unions, the fastest growing sector of the financial industry. Before we discuss our difficulties with non-profit competition, some review of the subject is in order. The following information has been compiled by our staff and the Business Coalition for Fair Competition, an organization made up of trade groups and coalitions similar to the Bankers Committee. We want to commend Joe O'Niel, Chairman of the BCFC for his terrific work in conjunction with these hearings.

INTRODUCTIONS

Unfair Competition by Nonprofits

The problem of unfair competition by nonprofits has rapidly become a top concern of small business. In 1980, the Congress and President Carter sponsored a White House Conference on Small Business. Nearly 2,000 small business owners, elected by their colleagues in local meetings, attended the conference. The delegates reviewed hundreds of proposals and selected 60, 15 of which were identified as immediate priorities. The subject of unfair competition by nonprofits received only cursory recognition and was not included in the top 15. In 1986, a second White House Conference on Small Business was held. This time, one session focused almost entirely on the issue of unfair competition, and the third highest recommendation of the Conference called upon government to eliminate unfair competition by nonprofits with small business. As recently as February, 1986, one small business group, the Small Business Legislative Council, reaffirmed the importance of this issue. The fact that the issue has generated such concern suggests that the problem is approaching crisis proportions.

Who are the Nonprofit Competitors?

The first step in an analysis of the problem is to define what is meant by "nonprofit". The term encompasses a wide variety of entities and is commonly associated with the federal tax-exemption (hereafter references to tax-exempt or tax-exemption refer to the exemption from Federal income tax). For the purposes of unfair competition, tax-exempts and nonprofits are virtually interchangeable terms. However, in theory, the term nonprofit describes a broad classification, of which tax-exempt organizations are but one subgroup. The common denominator of nonprofits is that their charter or articles of incorporation prohibits them from distributing their earnings to any individual or entity that exercises control over the organization., Historically, state laws limited nonprofits to certain purposes. Over time, states have removed this requirement; and, generally nonprofits may be formed for any lawful purpose. Even the term nonprofit is a misnomer. Distribution of the excess of income over expenses is not, in itself profit. Profit, in its purest sense, is the excess of revenue over expenses; many nonprofits enjoy such excess. Further, preservation and compensation of management or the expansion of capacity can drive profit motives as well as return on investment. To make a distinction merely on the distribution of earnings diverts attention from the larger issues.

As a practical matter, most significant nonprofits seek an exemption from federal income tax. The Exempt Organization Master File of the Internal Revenue Service listed over 841,000 entities at the end of 1985. These include voluntary and philanthrophic organizations such as schools; hospitals; social services; advocacy organizations; civic, social and fraternal organizations; arts and cultural organizations and foundations; religious institutions; credit unions, and other cooperatives.

Subchapter F of the Internal Revenue Code (hereinafter Code) includes 25 specific categories of exempt organizations. Credit unions are provided exemption under this section of the Code.

Estimates of the size of the nonprofit tax-exempt sector range up to $300 billion, of that credit unions contribute nearly $14 billion.

Nationally, there are almost 17,000 credit unions with total assets growing to $175 billion in March 1987. Percentage growth in 1986 compared to 1985 and earlier years has surpassed savings deposits and loan growth for all other financial segments. In 1983, credit unions held $54 billion in savings. This figure reached $126 billion by mid-year 1986 and $162 billion by march 1987. The growth rate for the year 1986 was more than twice the deposit growth rate for commercial banks. Through March 1987, percentage increase in savings for a twelve month period was at 22 percent.

Figures for loan growth are equally impressive. During 1986, loans at all credit unions grew from $74 billion to $96 billion or more than 13 percent. A substantial growth figure during a period of lower loan demand for most financial institutions.

New customers at credit unions have surged in recent years. As noted in an American Bankers Association monthly, the April 1987 ABA Banking Journal, "credit unions membership growth figure for 1986 is the highest since 1979." Credit unions now have over 55 million customers.

What Are The Advantages of Operation as a Nonprofit?

Unfair competition itself is easy to define, yet difficult to quantify. The unfair advantage is derived from the granting of special status by an external source, almost always the government, which either permits the entity to avoid governmental "burdens" (e.g., taxes) or to obtain direct support (e.g., grants). The exemption from federal taxation is the most significant of these advantages. Others include exemptions from state and local taxes, lower subsidized postal rates, and antitrust exemptions, to name a few.

Tax-exemption is the most recognized unfair advantage, but it is difficult to measure the extent of that advantage. The Internal Revenue Code includes a provision that requires the nonprofit to pay an unrelated business income tax on activities deemed to be unrelated. Only 22,000 organizations reported any unrelated activity in 1984. Credit unions generally do not pay UBI taxes. Although a lower postal rate or an antitrust exemption is important, there is no doubt that tax-exemption drives the nonprofit issue. It is the linchpin of the nonprofit system.

A significant "benefit" of nonprofit status is the aura of the government imprimateur. While the "aura" has been described as a rationale for the existence of nonprofits, it, in fact, has emerged as a major business advantage. The "contract failure" theory suggests nonprofits assure the public of quality and performance in services for which the consumer is not able to make such judgments. The evidence now suggests that, increasingly, the aura serves as a marketing tool as much as a method of quality control and protection.

The Impact of Unfair Competition

How do these exemptions or privileges provide advantage within the marketplace? The obvious answer is that the exemptions allow the credit union to lower the price of products or services. A less obvious advantage is the ability to sustain the costs of market entry. The chance to devote more resources to advertising, or underwrite new financial products is a tremendous advantage.

The damage of unfair competition is difficult to assess because the problem is national in scope, but local in impact. This explains, in part, why the phenomen hits the small bank sector particularly hard. The competition takes place on an institution-by-institution basis. A small bank competes against one credit union and one savings & loan. The central activity is the provision of banking services. Service, except for a limited number of franchise operations, does not lend itself to a national marketing strategy. A key index, if one were able to compile the data, is "opportunity lost." How many accounts were not opened or loans not made by the bank and how much tax not paid on those revenues? In a growing market, if a firm's increases 50% but a nonprofit has siphoned off another 50% of the potential growth, how is one to know?

The credit union sector has gained marketshare, and it is easier to document their gain rather than bank loss. The correlation is clear, and not surprisingly, the concern of the for-profit banking community regarding unfair competition has risen in direct proportion to the increase in the sale of goods and services by credit unions.

An examination of the new customers that contribute to this growth raises questions of the need and fairness of tax exemption.

New Products and Services Provide High Income Customers

Historically, infant industries have been granted tax subsidies to promote anticipated benefits to the American public. Judiciously, Congress has been called upon to remove tax favoritism and other regulatory benefits when self-sufficiency is achieved. When one examines the viability and robust condition of the credit union industry, it is obvious that tax exemption is no longer necessary. Importantly, this committee must examine more than the growth figures to determine who are the customers of credit unions. The customer profile is much different than what might be expected from a "self-help" organization intended to provide financial opportunities for low-income Americans. In fact, this examination of customers reaches the heart of our argument against continued tax exemption for credit unions. Have credit unions drifted away from their non-profit and/or mutual type organizational format?

The Credit Union National Association has from time to time published a national member survey. This extensive report contains nearly 100 tables and provides considerable information on typical credit union members and their use of financial services. The survey covers members and, for comparative purposes, non-members as well. While the study is slightly biased toward members of smaller credit unions, it is the best information available. To gain insight about the members of large credit unions, simply consider some of the top credit unions by name. The Navy Federal Credit Union with $2.1 billion in assets, the United Air Lines Credit Union with $1.1 billion in assets and the State Employees of North Carolina credit union with $1 billion in assets do not have a majority or large percentage of low-income customers.

Overall, the study found that credit union members are somewhat younger, more affluent and more concentrated in professional and managerial occupations than non-members. Credit union customers are more likely to own their own homes, and the average household income is $32,600 compared to $26,470 for non-members.

It is interesting that credit unions were viewed most favorable on price comparisons rather than services by survey respondents. Best loan rates and highest interest rates on savings were primary motivations for membership. 42% of credit union customers have incomes above $30,000.

The customer profiles raise the spector that credit unions are simply transferring federal benefits to individuals with the good fortune to work at a company that sponsors such an institution regardless of need or income.

Growth and expansion are the goal of any business organization, and the desire to aggressively compete with other sectors of the financial industry has moved credit unions toward higher income customers. The more affluent and better educated customers base of credit unions as outlined by the Credit Union National Association survey is due not only to pricing advantages bestowed by Federal and State tax benefits but also by an array of new products and services designed to attract such a high income market.

Consider the following examples of products and services; who might enjoy such products and whether the Federal government should subsidize the activities.

1) Litton Employees Credit Union offers members a discount brokerage product with margin accounts, and option trading. Similar services are offered by a number of credit unions including IBM's credit union services corporation, American Brokerage.

2) Over 3,000 credit unions offer VISA and Mastercard to their customers.

3) Credit unions now provide commercial loans by an act of the National Credit Union Administration Board. Other popular loan products include 1st and 2nd mortgages and unsecured consumer loans up to $50,000.

Along with new products, the deterioration of "common-bond" requirements for credit union membership allow credit unions to compete with banks and savings and loans for customers among the general public. Credit union regulators have determined that senior citizens that are members of a senior club (even if started by the credit union) qualify for membership. The American Bankers Association objected to the new policy saying "its clearly outside the intent of the law" regarding common bond membership. Many credit unions operate on a "geographic" common-bond, providing for a town or city-wide customer solicitation base. Another popular method of increasing membership includes expanding common-bond to so-called related companies. The following examples of expanded common bond provided by our members illustrates this trend.

1. Roanoke General Electric Employees FCU, Salem, VA (assets - $21,754,319), can increase its membership by 90,705 from members of the Alumni Association, Virginia Polytechnic Institute and State University in Blacksburg, employees of FIC Staff Services, Inc. in Charlottesville, employees of Carter Associates, Inc. who work at Roanoke Airport Marriott, Blacksburg Marriott Hotel, and Carter Associates, Inc. corporate office in Salem.

2. Mission FCU, San Diego, CA (assets - $236,639,000), can increse membership by 40,037 from employees of Scripps Bank and members of Ninth District Parent Teachers' Association, Inc. who work in San Diego County.

3. Bell International FCU, Pittsburgh, PA (members - 7,028), can increase membership by 6,849 from employees of Health & Welfare Planning Association in Pittsburgh, members of Pittsburgh Typographical Union No. 7, and members and employees of members of the North Hills Area Chamber of Commerce in Pittsburgh.

4. Nationwide FCU, San Francisco, CA (members - 6,924), can increase members by by 5,071 from employees of Miller Grove Travel Associates, employees of Columbia Savings and Loan who work in Mill Valley, employees of Crown Newsprint Sales and Forest Terminal, and retirees and senior citizens of the Zelpack Association in Emeryville.

5. Alburquerque U.S. Employees FCU, Alburquerque, NM (members 13,712), can increase membership by 4,170 from employees and members of the State Bar of New Mexico who qualify for membership, and employees of members who work in Bernilillo, Sandoval and Valencia Counties.

6. Leander Community FCU, Cedar Park, TX (potential members - 24,500), FoM consists of persons who live or work in portions of Williamson County.

7. Wright Patman Congressional FCU, Washington, D.C. (members - 22,430), can potentially increase membership by 9,200 from lobbyists and employees of lobbyists registered with the Clerk of the House of Representatives and who work on capitol Hill.

8. Forest Area FCU, Fife Lake, MI (members - 1,569), can potentially increase membership by 10,688 from persons who reside or work in Kalkaska County, MI.

How do these expansions meet well-defined common-bond requirements? Clearly, they fail to meet this vital test which qualifies the institutions for favorable tax treatment.

Solution - Tax Exemption Elimination Recommended

The changes in the operation and customer base of credit unions has caused the recommendation for a change in tax policy by the Carter Administration, the Reagan Administration, and 1985 Bradley-Gephardt tax reform package. Under the Treasury Department plan outlined in "The President's Proposals to the Congress for Fairness, Growth and Simplicity," credit unions would be subject to federal income tax on retained earnings. The report states that exemption "gives CUs a competitive advantage in attracting deposits from other financial institutions. Equity and neutrality demand that all financial institutions be taxed on all net income."

While many commercial banks would prefer to see taxation without regard to mutual ownership and the corresponding limitation on economic income of cooperatives, we endorse this tax concept for credit unions retaining a strict common-bond membership. Essentially, this proposal is an attempt to conform credit union taxation to current law regarding mutual type organizations. In fact, complete tax exemption is highly unusual treatment for cooperative membership organizations. Credit unions that want to compete in the financial market for customers from the general public, should be denied a member dividend deduction and taxed accordingly.

Credit union representatives maintain that credit unions are financial cooperatives; those that fulfill this definition, they should be taxed as such. The Ways and Means Committee revenue proposal on credit unions included in the list of possible revenue raisers for FY 1988 accomplishes such, as would move toward fair and equitable tax policy.

Thank you very much.

**BELTONE
HEARING AID
CENTER**

AUTHORIZED BELTONE
HEARING AID DISPENSER

1300 AVENUE C
BILLINGS, MT 59102
TELEPHONE 259-7983

Beltone®
Better Hearing Through Professional Care

June 19, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means,
U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Sir:

The situation is becoming critical within the small business community regarding non-profit organizations who use unfair trade practices to compete with retail businesses. Tax-paying businesses who, in effect, support these very organizations.

In our particular instance it is the local Easter Seal Society which has established audiological facilities throughout the State and which boldly advertises as being non-profit and, thereby, more beneficial to the prospective client. Please refer to the sample advertising enclosed.

Special privileges all combine to enable the Society to operate at lower cost than can the private sector. These privileges include exemption from federal and state income taxes and local business and property taxes; reduced costs of postage and advertising; charitable contributions; use of facilities and equipment that are subsidized through school testing programs; and unlimited sources of potential customers generated through organizational contacts (special transportation, etc.).

The Society implies that it has only the public's interest at heart, and will deny any interest in the generation of profit. However, a glance at the advertising will show it to be purely for commercial purposes.

PLEASE HELP US. Legislation is needed immediately to control the special privileges of non-profit organizations before private enterprise on a small scale becomes impossible.

Yours very truly,

BELTONE HEARING AID CENTER

Ervin E. King

Ervin E. King

ERVIN E. KING • CERTIFIED HEARING AID SPECIALIST
SPECIALISTS IN SCIENTIFIC FITTING AND SERVICING OF HEARING SYSTEMS

NO-OBLIGATION HEARING EXAM*.

WHAT'S FREE, BUT ISN'T CHARITY?

Our no-obligation hearing exam. It's not charity. It's just a great, no-risk way for you to be sure you're hearing clearly. And another way Easter Seal dollars go right back into Montana, providing health care services for you and your family.

So, if you've been turning up the stereo or TV louder than before, or find yourself asking people to repeat themselves, it's time for you to find out if you have a hearing loss for sure. For free. With no obligation to buy anything, ever.

- Complete audiological testing by licensed, experienced audiologists
- Wide selection of Hearing Aids
- Hearing Aid Sales & Service
- Financial Assistance Program

If a hearing loss is detected, we can help you select the hearing aid that's best for you, and fit you – at a cost you can afford. Since we're a non-profit organization, the only one who benefits is *you*.

Sound good? Then call today for an appointment for your no-obligation hearing test.

* Special offer available to adults only

252-9600 (Billings)
538-8448 (Lewistown)

Easter Seals Hearing Services
"Where people come first"
Serving: • Billings • Great Falls • Havre • Lewistown • Cut Bank • Conrad • Shelby • Glasgow

©1987 PBAA

Easter Seals

SCIENTIFIC FITTING AND SERVICING OF HEARING AIDS • LICENSED BY THE STATE OF MICHIGAN

Beltone HEARING AID CENTER
AUTHORIZED DEALER FOR THE NEW BELTONE

723 EAST EIGHTH ST.
TRAVERSE CITY, MICH. 49684
TELEPHONE 616—947-4960

WILLIAM SHOLTEN - DEALER

July 13, 1987

Robert J. Leonard, Chief Counsel
Committee of Ways and Means
Longworth House Office Building, Room 1102
Washington, DC 20515

Dear Sir;

I am a certified hearing aid audiologist for Beltone Hearing Aid Center, a for-profit business which engages in the testing of human hearing, and when appropriate, dispenses hearing aids to compensate for hearing loss. As a for-profit company, we pay federal and state income taxes, plus local property tax. We question the ethics involved in the unfair business practices of tax-exempt hospitals and clinics, and object to finding ourselves in direct competition with alledged "non-profit" organizations.

Our primary tax-exempt competitor, Munson Medical Center's Speech and Hearing Department, has the enormous resources of the parent institution, as well as grant and donated funds which allows the purchase of otherwise unaffordable equipment, pays the overhead, and allows discounting which could ruin a small, independant businessman. With their huge public relations budget, the Speech and Hearing Department can and does "out-advertise" us regularly.

Newspapers, radio stations, and television stations often provide gratuitous advertising for our tax-exempt competitors, in the guise of public service announcements, bolstering the public image of hospital affiliates as public servants.

The Speech and Hearing Department of Munson Medical Center benefits from the incalculable advantage of the public image of "the Doctor" and "the Hospital", while we are afflicted with the image of "the Saleman", an image which is fostered through the hospital's advertising.

We find that the tax-exempt organizations are in increasing competition with us in the dispensing of hearing aids. This competition has increased dramatically as the tax-exempt organizations have extended their practice beyond patients referred by physians and have begun mass marketing hearing aids to the general public. I am enclosing some examples of advertisements for this "non-profit" organization.

Munson Medical Center has adopted standard commercial practices to sell hearing aids to the general public. They are virtually identical to our business in operations, but for one crucial factor - because it is tax-exempt, it can receive an influx of capital in tax-deductible donations, and it enjoys all of the other benefits of being a "non-profit" organization.

It would be ironic indeed if the tax revenue paid by small businesses such as this one were to be eradicated as a result of competition from "non-profit" organizations. Surely this cannot be the result Congress intended in allowing exemption from taxation for certain charitable purposes.

I urge you to consider the impact on for-profit, tax-paying businesses by the activities of non-profit, tax-exempt competitors.

Most sincerely,

Karen S. Maas
Certified Hearing Aid Audiologist

WE OBJECT TO MUNSON HOSPITAL, A PUBLICLY-FUNDED, NON-PROFIT ORGANIZATION, GOING INTO DIRECT COMPETITION WITH PRIVATE ENTERPRISE BY SELLING HEARING AIDS THROUGH THE SPEECH AND HEARING DEPARTMENT OF MUNSON MEDICAL CENTER.

1. The Speech and Hearing staff do not adhere to State of Michigan licensing regulations.
2. Since the salaries of the staff are paid by the hospital, and that hospital is a "non-profit" organization, why are they selling and dispensing hearing aids? Where can the profits go, except to continued large-scale and expensive advertising for the sale of hearing aids?

WE OBJECT TO THE MISLEADING AND EVEN UNTRUE ADVERTISING WHICH MUNSON SPEECH AND HEARING DEPARTMENT HAS BEEN PUBLISHING.

1. The ads specify the amount of money a hearing aid SHOULD cost, without mentioning substantial hidden costs which are attached to the cost of aids sold by Speech and Hearing, i.e. cost for testing and consultation, "administration fee", and earmolds.
2. They attack our marketing techniques and business practices directly, advising the hard of hearing public IN PRINT not to "buy your hearing aid from someone in a motel room" and refering to gold circuitry as a "gimmick", whereas in truth, gold is known to be one of the finest electrical conductors known. It can be established that gold is superior to other commonly used materials.
3. The audiologists a the Speech and Hearing Department have Masters Degrees in Audiology. But they are not medical doctors. They state in their advertising that they have degrees in "the diagnosis and treatment of hearing loss", but such diagnosis and treatment is the province of medical doctors only.

The Fitting of Hearing Aids is a Science... Leave it to the Professionals

See the Specialists for Proper Hearing Aid Fitting:

Munson Medical Center's hearing specialists all have a Master's degree in the diagnosis and treatment of hearing loss and are certified by the American Speech and Hearing Association.

Munson has the most up-to-date technology to precisely fit your hearing aid. New equipment uses a tiny microphone placed in the ear canal to provide you the best posible hearing aid fitting.

What Munson profesionals will not do:

- Attempt to sell you a hearing aid with a gimmick, such as "gold" circuitry.
- Be more interested in selling you a hearing aid, or maybe two, than in assessing your degree of hearing impairment and fitting you properly.
- Will not call the purchase final until you have had a trial period.

How Much Should a Hearing Aid Cost?

In Northern Michigan a premium, top of the line, hearing aid should cost between $375 and $450. If two hearing aids are purchased, the total cost should be no higher than $750.

If you have questions about your hearing, or that of a family member or friend. If you are age 55+, we invite you to have a free hearing screening.

Call the Speech and Hearing Department at 922-9455

PREVIEW, JULY 6, 1987

ED SMITH and New Ear Lab

Munson Launches Second Mobile Ear Lab Unit

Due to a continuing public demand for hearing assessment services, Munson Medical Center has obtained a second Ear Lab mobile audiology unit which will cruise the highways of northern Michigan, serving patients throughout an 11-county area.

The Ear Labs are vehicles outfitted with audiological equipment designed to measure the patient's level of hearing. The vehicles bring all the services of an audiologist's office to areas of northern Michigan which have not had hearing assessment services in the past.

Munson's original Ear Lab, obtained in 1983, has completed 8,120 free hearing screenings and over 4,000 fee-for-service assessments in the past four years, logging more than 60,000 miles in the process. "We've found that there really is a great demand for this service and a need for a second mobile unit," said audiologist Ed Smith, director of Munson's Speech and Hearing Department.

Unlike the original unit, which is housed in a 30-foot recreational vehicle, the new Ear Lab II is mounted on a truck chassis for greater durability and features a wheelchair lift. The unit is designed to serve any patient, aged five months and older, using the resources of a clinical audiometer to measure hearing sensitivity, a tympanometer to assess eardrum flexibility, and equipment for fitting various makes and models of hearing aids.

The $80,000 unit was funded by a 50/50 grant from a private foundation, which wishes to remain anonymous, and by the Hattie Hannah Keeney Foundation, Smith said. Munson's mobile audiology service is also subsidized by an annual grant of $8,000 from the Northwest Michigan District Lions Clubs, which sponsor an average of 45 free hearing screenings per year in outlying communities.

Smith added that a portion of the funds obtained from the foundations will be used to rejuvenate the original Ear Lab, which will then provide back-up services in times of high demand.

Overall, the Ear Labs will service the free screenings offered by the Lions as well as five intermediate school districts, a growing number of industrial clients, and six regional hospitals, including West Shore in Manistee, Paul Oliver Memorial in Frankfort, Kalkaska Memorial, Leelanau Memorial in Northport, Grayling Mercy, and Charlevoix Area Hospital.

BEST AVAILABLE COPY

and utility [illegible] plication included several examples of un-safe conditions that will be cared for with this grant. A review panel will be selected and applications will be put in priority order. More information, as we receive it, will be given.

HELP WANTED

Responsible person to package and deliver home-bound meals. Must have car. Three hours per day. All deliveries in Elberta-Frankfort area. Call the Commission on Aging office at 882-4851.

EAR LAB

In cooperation with Munson Medical Center the Commission on Aging will sponsor an "Ear Lab" clinic days. The goal of this clinic is to identify seniors in our community who have hearing impairment, and to direct them to qualified professional services. The screening is free. It only takes about 10 minutes but you need an appointment. At Harborview Senior Center on Tuesday, July 21, call the Commission on Aging office at 882-4851; Wednesday, July 22 contact Elsie Krimm at Colfax Township Hall 378-2144. If you presently wear an aid, it can be checked to see if it is functioning properly or in need of replacement.

We're Going Your Way!
BENZIE COUNTY

The Maxi - Taxi is available to all seniors in Benzie County. Call 882-9671, Extension 34, between 9:00 a.m. and 5:00 p.m. weekdays. 24 hour notice is requested.

cluded [illegible] with volunteer Mary Arner for residents Dorothy Williams, Bertha King, Mary Keillor and Helen Showalter and entertainment by a youth group from the Manton Wesleyan Youth Camp.

A special Father's Day breakfast was served in the Blue Room, cooked by Lana Knight, Assistant Activities Director. Those residents attending were: Charles Hodge, Ward Johnson, Mearriall Biller, Bill Schleuter, Richard Jaworski and Paul Fitzhugh. The men loved the juice, French toast, sausage, bacon, fresh fruit and coffee Lana prepared for them, the "love knots" made for each one of them by our kitchen crew, and conversation about cars they had owned in the past.

The Rev. and Mrs. Howe of the Blaine Christian Church, who have only been in this area for 3 weeks, conducted the Sunday service. The residents welcomed them, and are looking forward to their next visit.

Shuffleboard? The Red Rascals, after a slow start, finally tromped the Green Hornets 158 to 119. Five straight weeks!

♪♫ JUNE MADNESS ♫♪

Tuesday, June 30th, 8-11 p.m.
American Legion Hall, Frankfort
Donation $2 - Refreshments Are Available
Dance Is Open To The Public

NOTICE....

Commission on Aging meeting will be held Tuesday, July 7th at 1 p.m. at Harborview Senior Center. Everyone is welcome to attend. Call 352-4280 for your meal reservation today.

FRANKENMUTH TRIP

Thursday, July 16th
Cost $20 per reservation
Call Mary Ann at 352-4280 for further details

REMINDER....

Your Benzie County senior center is still saving "Sanka" seals. We would like to purchase a colored TV or a microwave to be raffled at a later date. This is another idea for a fund raiser - Please Help!

Kitchen Band meets every Wednesday at 1 p.m. at the center. We are in need of a piano player. Can you help us out?

Father's Day celebration held on Friday, June 19th a smashing success. Complete chicken dinner topped-off with apple pie was delicious. Fifty seniors attended the gala event (including 15 men). Winner of our mini-raffle (3 lb. can of coffee) was Frank Pierce. Profit made was $13.

Have a "safe" and "happy" 4th of July

Wednesday, 7 p.m.

BLOOD PRESSURE MONTHLY CLINIC DATES & PLACES

First Monday of eacl month at the Colfa Town Hall, 12:30-1:3 p.m.

Second Monday o each month at Inlan Township Hall i Bendon, 1-3 p.m.

Third Monday (each month at tl Harborview Senic Center in Frankfoı 1-3 p.m.

Second Thursday each month at Mi Community House Benzonia, 2-4 p.m.

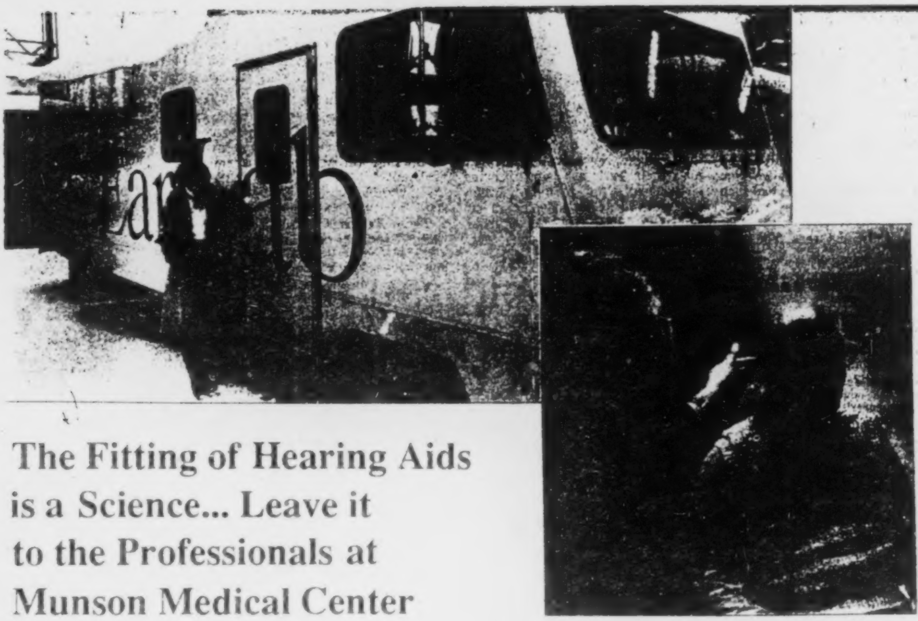
Fourth Friday each month at Hon stead Township Hall Honor, 11:30-1:30.

sponsored by
HSB THE HONOR STATE BANK
Member F.D.I.C.
325-8031 882-9611

CRYSTAL PLAZA
FARMER JOHN'S
U.S. 31 S. BENZONIA
882-4021

sponsored by

CENTRAL STATE BANK
FDIC
49 Benzie Blvd.
882-4462
Beulah



The Fitting of Hearing Aids is a Science... Leave it to the Professionals at Munson Medical Center

There are many hearing aids on the market and choosing where to go to purchase one can be confusing.

Claims and promises are made regarding the uniqueness of each brand and model. Many gimmicks are heralded as fantastic advances. Munson Medical Center's hearing specialists put the proper fitting of hearing aids over and beyond all else. They know that the fitting of hearing aids is a very individual matter. What may work for one person is not at all suitable for the life-style or comfort of another. They are not obligated to promote a particular brand.

These specialists have master's degrees in the diagnosis and treatment of hearing loss and are certified by the American Speech and Hearing Association. Their skills, along with the most up-to-date technology, means they can fit your hearing aid with precision. New equipment uses a tiny microphone which is placed in the ear canal to provide you the best possible hearing aid fitting.

What's more, once you have received the aids prescribed for you we will not call the purchase final until you have had a trial period and you are completely satisfied.

If you've been shopping around, and you are worried about high costs, don't despair, our costs are very reasonable. A quality, top-of-the-line hearing aid should cost between $375 and $450. If two hearing aids are required, the total cost should not be higher than $750.

If you have questions about your hearing, or that of a family member or friend, call us about the options, including the mobile Ear Lab, for free hearing screening for all age 55+.

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P. O. BOX 5777
FLORENCE, S. C. 29502
TELEPHONE: 669-0119

To Whom It May Concern:

The Pee Dee Speech and Hearing Center, a state operated non-profit office in our area, sells hearing aids in direct competition with our office. Recently the unfairness of a state agency competing with a private small business was reemphasized to us when the Speech and Hearing Center was GIVEN - at no cost to them - time on a local TV station to promote Better Speech and Hearing Month and at the same time told people to come to them and get their hearing aids.

How can a small businessman be expected to compete with this? The cost for us to use television advertising is extensive.

We only hope that Congress will see the unfairness of this and act now!

Sincerely,

Eules Morgan

Eules T. Morgan, BC-HIS
Certified Hearing Aid Specialist

ETM/dd

Beltone
WHEN A HEARING AID WILL HELP

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ENTERPRISES, INC.
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HEARING AID
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AUTHORZIED BELTONE DEALER

209 JEFFERSON STREET
WAUSAU, WI 54401
TELEPHONE: 715/842-9882

Robert J. Leonard, Chief Counsel
Committee on Ways & Means U.S. House
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Mr. Leonard and Representatives

This letter is being written to provide the House Ways and Means Committee with information about the major effects- of current and growing unfair non profit competition with small tax paying business. Although this letter will focus on the effect on hearing health care business, it should be noted that many of the problems which will be discussed are being faced by a large number of industries, and hopefully all will present their individual concerns as I now will. I would first like to thank the Committee for this opportunity to present this information on this very important issue. I have been notified that the National Hearing Aid Society will present oral testimony which will provide on overview of the problems faced by our profession as a whole so I wish to inform you of how this problem affects my small business and the people under my care.

In 1976, the Beltone Hearing Aid Center in Wausau, Wi. entered the hearing health care field with a goal of providing the hearing impaired of Wausau and the surrounding area with the highest quality hearing care available. The past eleven years of dedicated service, by the entire staff, has resulted in a local community enjoying an atmosphere in which the importance of hearing health care is understood, maintained and advanced. In recent years the problem of non profit hospital dispensing and university dispensing has allowed these opportunistic groups to use their tax advantages and the illusion of a "non profit", altruistic image to capture a large part of this commercial activity. It is appalling to realize that the "profit" or "excess revenue over dispersements" are benefiting the staff through higher wages or increased advertising which will further adversely affect our tax paying business. Equally disturbing to business owners

JAMES OGUREK · DEALER · HEARING AID SPECIALIST · STATE LICENSE NO. 298

SPECIALISTS IN SCIENTIFIC FITTING AND SERVICING OF HEARING AIDS

is reading that sales represent 76.3% of non profit revenues yet they receive preferred tax treatment, postal rates and also the public view that "non profit concerns" must somehow be preferred since the government recognizes them as such. As a business person, if the problem is not corrected the economic concepts on which America was built - economic growth through free, fair and open competition - will die, and the successes of the past will not be repeated.

Beyond the effect of the current "non profit" commercial activity on business, it is important to look at the effects on the hearing impaired if this problem is not corrected. For nearly fifty years our parent company and many others have educated, motivated and served the hearing impaired by providing a wide variety of hearing aid delivery systems including; traditional hearing aid offices, periodic service center visits to small communities, and the availablilty of housecalls to those who require or desire them. This diversified delivery system has extended quality hearing health care throughout the U.S.. The growth of "non profit" hearing aid dispensing operations allows them to change the delivery system by using their advantages to absorb small businesses and then require that people travel to their offices for all services they require. These "altruists" care enough to make "excess revenues over dispersements", but not enough to make a housecall and it is the hearing impaired who will suffer. The hearing impaired deserve the right to choose between providers who actively compete for the opportunity to serve them, who pay taxes and expenses equally and survive based on their own performance, and not by any umbrella of public confidence provided by a public institution.

The idea of "non profit" was introduced to assist charitable organizations, by providing tax preferred status, in achieving truly altruistic goals. The goal of this concept is good but opportunistic organizations have used this to amass personal fortunes. This must be halted!

Beltone

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BELTONE
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CENTER

AUTHORZIED BELTONE DEALER

209 JEFFERSON STREET
WAUSAU, WI 54401
TELEPHONE: 715/842-9882

The United States Government should change the tax code and business climate by eliminating the "non profit" corporation. In its place the Government should provide tax assistance to corporations based on the degree to which the corporation is funded by charitable donations. For example; if a corporation receives 75% + of its revenue from donations, it would pay 0% tax, 50-75% donations would pay 30% of standard corporate tax rate, 25-50% donations would pay 50% of corporate rate, etc.. With this or similiar change, the benefits of competition will be preserved while still providing tax benefits to the truly charitable institutions.

Thank you for addressing this important issue and I am looking forward to the recommendations of this distinguished committee.

James Ogurek

James Ogurek

JAMES OGUREK · DEALER · HEARING AID SPECIALIST · STATE LICENSE NO. 298

SPECIALISTS IN SCIENTIFIC FITTING AND SERVICING OF HEARING AIDS

Beltone
Better Hearing [illegible]

JOHN BARTOLUCCI
PRESIDENT

June 9, 1987

Robert J. Leonard, Chief Counsel
Ways & Means Committee
U.S. House of Representatives
Longworth House Office Building, Rm 1102
Washington, D.C. 20515

To Whom It May Concern:

Dear Sirs:

I am writing this letter after receiving a notice of Congressional Hearing in tax exempt (nonprofit) organizations engaging in commercial enterprises. I understand that a meeting will be held during the week of June 22 in Washington D.C.. I am very concerned in the results and subject matter.

From personal experience (being a hearing aid dealer in Western Massachusetts), I have been subject to wide-spread abuse through unfair competion from (nonprofit) organizations. Such organizations, to name a few, Mercy Hospital in Springfield,MA; Franklin County Hospital in Greenfield, MA; Berkshire Medical Center in Pittsfield, MA; Hampden Hearing Centers in West Springfield and East Longmeadow; Clark School for the Deaf in Northampton, MA; all of the above are so called (nonprofit) organizations that within the past 5 years have begun dispensing hearing aids, batteries, accessories, and repairs for a profit using commercial techniques in advertising and even in one case (Franklin County Hospital) opening up a store-front branch office away from the hospital to retail these products.

As far as I know none of these (nonprofit) organizations are subject to Federal taxes, State taxes or local taxes which other small businesses are subject to, including local property tax, sales tax on equipment, personal property tax, corporate income tax, federal and state.

Most of these (nonprofit) organizations also get lower rates for postage and can compete with other hearing aid dealers by sending out large mailings for advertising their products. Mailings which would be cost prohibitive to most tax-paying hearing aid dealers who would have to pay full postage. I certainly hope the Committee would give very careful consideration to the lost tax dollars. The unfair competition that is resulting from this recent surge of (nonprofit) organizations dispensing hearing aids, to increase their revenue, without regard for tax-paying small businesses that they are taking the customer away from. Competition between commercial for-profit firms and tax-exempt organizations is increasing. Markets traditionally served by small, for-profit firms are now being offered products and services produced by tax-exempt, not-for-profit entities.

While the public perception of tax-exempt organizations is that they derive most of their income from charitable contributions and tax revenues, according to reports filed with the Internal Revenue Service (IRS), they derive 76 percent of their income from sales. In contrast, their gifts and dues income represents only 23 percent of their income. Of course, some of the sales may be charged for such things as publications, that are clearly part of the nonprofit's charitable, educational or cultural mission serving the needy, the sick and disabled or association members. However, the competion posed by many of these sales activities is unfair and should be dealt with.

You may ask, "What is unfair"? Products and services which are offered by a nonprofit in direct competition with products and services offered by small, for profit business provide the basis for the charge of "unfair" competition. The unfair aspects are:

1) The nonprofit may pay no Federal, state or local taxes on profits generated from sales of products and services.
2) The nonprofit may be tax-supported.
3) The nonprofit may use nonprofit mailing rates in its sales promotion activities.

June 9, 1987

4) The nonprofit may be exempt from normal taxes borne by most businesses such as sales tax, inventory tax and property tax.
5) The nonprofit may operate using rent-free facilities and a work-force paid in part or in whole by public funds.

I would think some of the solutions could be:

1) Prohibit nonprofits from competing with for-profits.
2) Reform the Revenue Code and IRS regulations and procedures to tax profits earned by nonprofits.
3) Deny nonprofit tax status to those entities which compete with for-profits.

I would certainly appreciate knowing results and opinions that are derived from your June meeting.

Thank you very much.

Sincerely,

John Bartolucci

John Bartolucci
Certified Hearing Aid Audiologist
Board Certified in Hearing
Instrument Sciences

JB/sd
cc:National Hearing Aid Society
Massachusetts Hearing Aid Society

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IF NO ANSWER 414 - 452-1777

James A. Bohren
Certified Hearing Aid Audiologist
Board Certified (NBC-HIS)
Authorized Dealer for Beltone Hearing
Aids and Audiometers

June 10, 1987

Robert J. Leonard, Chief Counsel
Ways and Means Committee
U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

RE: Abuses of Tax Exempt Status by
Tax-exempt (Nonprofit) Organizations

Dear Mr. Leonard:

In anticipation of the hearings by the House Ways and Means Oversight Committee the week of June 22nd regarding abuses of tax exempt status, I would like to take this opportunity to make you aware of the serious nature of the problem as it relates to tax paying for-profit small business people in Wisconsin and nationally. You are most likely aware that abuses of tax exempt status was the number three concern nationally at last summer's White House Conference on Small Business.

First of all, I am not anti nonprofit organization; the Boy Scouts/Girl Scouts, Big Brothers/Big Sisters Organizations operate well under their nonprofit tax exempt status. The big offenders are the YMCA's and hospitals getting into commercial ventures that compete with for profit business. Hospitals are opening for profit pharmacies, dispensing hearing aids, using excess laundry capacity to do laundry for hotel and motels in competition with for profit laundries. These commercial activities are clearly out of the realm of activity of these nonprofit organization's origional mission when their tax exempt status was granted. Even if the nonprofit does form a for profit corporation for their commercial activities, the venture capital to start the for profit corporation is coming from the tax exempt dollars of the nonprofit corporation. If I want to expand my business, I have to borrow my venture capital from a bank or other financial institution. This situation is a very unfair advantage for the nonprofit organization. Millions of dollars of profits from these commercial ventures are not taxed.

Competition between commercial for-profit firms and tax-exempt organizations is increasing. Markets traditionally served by small, for-profit firms are now being offered products and services produced by tax-exempt, not-for-profit entities.

While the public perception of tax-exempt organizations is that they derive most of their income from charitable contributions and tax revenues, according to reports filed with the Internal Revenue Service (IRS), they derive 76 percent of their income from sales. In contrast, their gifts and dues income represents only 23 percent of their income. Of course, some of the sales may be charges for such things as publications, that are clearly part of the nonprofit's charitable, educational or cultural mission serving the needy, the sick and disabled or association members. However, the competition posed by many of these sales activities is unfair and should be dealt with.

The basic question is, "What is unfair about competition from nonprofits?" Products and services which are offered by a nonprofit in direct competition with products and services offered by a small, for-profit business provide the basis for the charge of "unfair" competition. The unfair aspects are:

1.) The nonprofit may pay no Federal, state or local taxes on profits generated from sales of products and services.
2.) The nonprofit may be tax-supported.
3.) The nonprofit may use nonprofit mailing rates in its sales promotion activities.
4.) The nonprofit may be exempt from normal taxes borne by most businesses such as sales tax, inventory tax and property tax.
5.) The nonprofit may operate using rent-free facilities and a work-force paid in part or in whole by public funds.
6.) Venture capital from non-profit organizations may be used to start spin off for-profit corporations.

What are some solutions to this problem? A few solutions would be:

Prohibit nonprofits from competing with for-profits.

Reform the IRS Code and procedures to tax profits earned by nonprofits.

Deny nonprofit tax status to those entities which compete with for-profits.

Prohibit nonprofits from using tax exempt dollars as venture capital in setting up spin off for-profit corporations.

Some specific examples of unfair competition in my area of Wisconsin by nonprofits are the following: My local YMCA has opened a health club in direct competition with local for profit health clubs. The YMCA has a child day care center in competition with local for profit child day care centers. Our local Memorial Medical Center (hospital) has opened and is advertising its cafeteria to the general public giving senior citizen discounts. This is in direct competition with local tax paying restaurants.

Plymouth Valley View Medical Center (hospital) has opened a retail pharmacy in Elkhart Lake, Wisconsin. Venture capital for startup and employee salaries coming from the nonprofit hospital. This pharmacy is in direct competition with local tax paying pharmacies.

St. Agnes Hospital in Fond du Lac, Wisconsin has been dispensing hearing aids for a number of years in direct competition with local tax paying hearing aid dispensers.

The Sheboygan, Wisconsin Rehabilitation Center as a supplement to their budget is in the recycling business in direct competition with the local tax paying recycling businesses.

Numerous hospitals in Milwaukee and Southern Wisconsin are dispensing hearing aids in direct competition with local for profit dispensers. One for profit dispenser in Kenosha, Wisconsin saw his office gross income drop from $100,218.00 to $63,565.00 from October 31, 1985 to October 31, 1986. This took place right after Kenosha Memorial Hospital started dispensing hearing aids.

As you can see Mr. Leonard, I am not whistling in the wind with my concerns; tax paying small business people throughout the nation need action by the Ways and Means Committee. I am all for competition and I have plenty, but I would like my competition to pay taxes and operate under the same ground rules I have to!

As I stated before, these commercial activities are clearly out of the realm of activity of these nonprofit organizations' origional mission when their tax exempt status was granted.

As you can see by my enclosed letters from the Lt. Governor and Revenue Secretary of Wisconsin, they are concerned about the problem and are waiting direction from Washington. Thank you for your consideration.

Sincerely,

James a. Bohren

James A. Bohren
Certified Hearing Aid Audiologist
Board Certified (NBC-HIS)

JAB:sk
enc.

CC Senator Robert W. Kasten, Jr.
Senator William Proxmire
Congressman F. James Sensenbrenner
Congressman Thomas Petri
Congressman James P. Moody
James Lovell, National Hearing Aid Society
Abe Schneier, National Federation of Independent Business

State of Wisconsin ● **DEPARTMENT OF REVENUE**

125 SOUTH WEBSTER STREET ● P.O. BOX 8933 ● MADISON, WISCONSIN 53708 ● 608-266-6466

Tommy G. Thompson
Governor

Karen A. Case
Secretary of Revenue

John W. Torgerson
Deputy Secretary

Mark D. Bugher
Executive Assistant

May 19, 1987

Mr. James A. Bohren
Beltone Hearing Aid Service
1933 North 8th Street
Sheboygan, WI 53081

Dear Mr. Bohren:

Thank you for your recent letter to Governor Thompson concerning the tax status of nonprofit organizations. Your letter raises several points which are receiving serious consideration both at the state and federal level.

The issue of property tax exemptions for nonprofit organizations is currently under study by the Governor's Local Property Tax Relief Commission, of which I am a member. The Commission is currently studying a proposal to require in-lieu of tax payments or municipal service fees for property owned by nonprofit organizations.

The department is also monitoring events in Congress concerning the taxability of nonprofit organizations for federal income tax purposes and the definition of what services and products nonprofit organizations can legally provide. Any tax law revisions enacted by Congress in this area will be reviewed by the state Legislature, which must decide whether or not to incorporate the revisions into the Wisconsin tax code.

If I can be of further assistance on this matter, please feel free to write to me.

Sincerely,

Karen A. Case

Karen A. Case
Secretary of Revenue

KAC:brm

cc: Governor Tommy Thompson
Lt. Governor Scott McCallum
Senator Russell Feingold
Senator William Te Winkle
Senator Donald Stitt
Representative Marlin Schneider

R1833138

Office of Lieutenant Governor
State of Wisconsin

Scott McCallum
Lieutenant Governor

May 29, 1987

Mr. James A. Bohren
Beltone Hearing Aid Service
1933 North 8th Street
Sheboygan, WI 53081

Dear Mr. Bohren:

Thank you for the copy of your letter on abuses of tax exempt status by non-profit organizations you mailed to Governor Thompson.

Your points are thoughtful and very convincing. Closing certain tax loopholes would indeed impact favorably upon property taxes. I will keep your letter on file and discuss its points with the Govrnor.

If I can be of additional assistance, please do not hesitate to contact me.

Sincerely,

Scott McCallum

Scott McCallum
Lieutenant Governor

SM/RM/k

Room 22 East • State Capitol • Madison, WI 53702 • (608) 266-3516

ACI Auditory Centers
111 East Wisconsin Avenue
Suite 725
Milwaukee, Wisconsin 53202
(414) 273-2434

February 25, 1987

Mr. Doug Johnson
Executive Secretary
Wisconsin Alliance of Hearing Professionals
300 W. Mifflin Street
Madison, WI 53703

Dear Doug:

I want to thank you, James A. Bohran, the Wisconsin Alliance of Hearing Professionals and the Wisconsin Merchants Federation for an excellent chapter meeting. I also want to express my desire to pursue the effects of non-profit hospitals, clinics, universities and HMO's on small, private businesses.

I know that Kenosha Memorial Hospital has had a significant effect on all for profit dispensers in the Kenosha area. Sales in our ACI Auditory Centers Kenosha office dropped from $100,218 to $63,565 from October 31, 1985 to October 31, 1986. Over the past 18 months we have taken a real beating in the Kenosha marketplace.

Doug, I think you know me well enough to understand that I don't mind competition, however, I would like the non-profits that decide to buy their way into the hearing health care business to be taxed appropriately. Kenosha Memorial Hospital's program is a simple social program designed to get the hospital into the hearing aid business. They felt the quickest way was to run a discount program. After they have made a significant impact and perhaps caused a few dispensers to go out of business, they will raise their prices.

I think Governor Thompson and the IRS should be aware of the effect on small business in our state.

Sincerely yours,

Otis A. Whitcomb, M.A.
President

— Better Hearing Through Professional Care —

Tax-exempt status called too broad

Madison, Wis. —AP— The Legislature should review laws that grant a wide variety of organizations tax-exempt status, the Legislative Audit Bureau says.

The audit bureau said it found that local tax exemptions had been granted to groups as diverse as a barbershop quartet, a drum corps and a foundation providing financial aid to former golf caddies.

Clear definitions should be established for what constitutes "benevolent and educational associations."

The report said a typical Wisconsin homeowner could have saved $92 in property taxes last year if all private tax-exempt property had been taxed.

The bureau said, however, that it was unlikely that the Legislature would ever repeal exemptions, which are also granted to non-profit hospitals, labor temples and buildings owned by fraternal societies.

The bureau said the State Department of Revenue should revise its regulations to clarify that YMCA and YWCA property was exempt from taxation only to the extent that it was used for educational and religious purposes.

The bureau said local assessors had become concerned that YMCAs and YWCAs had turned from their original missions to become more like health clubs in competition with the private sector.

About 29% of all real property in Wisconsin is tax exempt, the bureau noted. Of that total, 67% is owned by federal, state and local governments, 10% is owned by religious associations and the remaining 23% is owned by private, non-profit groups.

MILWAUKEE JOURNAL

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JUN 10 1987
WAYS AND MEANS

Robert J. Leonard, Chief Counsel
Ways & Means Committee
U.S. House of Representatives
Longworth House Office Bldg, Room 110
Washington, D.C. 20515

June 17, 1987

Dear Mr. Leonard,

This written statement is being submitted in regard to the Congressional hearings into tax-exempt organizations engaging in commercial enterprises. We have had direct experience with nonprofit competitors.

In the Pittsburgh area, Eye and Ear Hospital, and Pittsburgh Hearing and Speech Association, as well as other government-funded public facilities have directly competed with the hearing aid dealers in the area. They are using non-profit hearing aid shelters to dispense the instruments at very unfair prices (very uncompetative). The enclosed ad copy is just one of the many ads and public screenings which take place regularly at the taxpayer's expense. Other small businesses in the area, as well as myself pay such taxes.

Pittsburgh Hearing and Speech has a mobile unit with the facilities to test hearing. They encourage people to purchase aids from them directly.

Therefore, our main complaint is the use of government-funds by tax-exempt (nonprofit) organizations to compete directly against established hearing aid dispensers, using unfair market prices and advertisements. Keep in mind that the above mentioned hearing aid businesses pay the taxes used by the nonprofit competators.

Sincerely,

William E. King, BC-HIS
PA License #2182

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PATRICIA A. KING, VICE PRESIDENT
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Pennysaver MAY 11, 1987

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502 Jackson St., Vidalia, GA 30474
912-537-1101

Medical Associates of Metter
Cedar St., Metter, GA 912-685-5715

709 E. 65th St., Savannah, GA 31405
912-352-8530

Robert J. Leonard, Chief Counsel
Committee on Ways and Means, U.S. House of Representatives

On June 22, 1987 Congress will be considering an issue that is fundamental to our free enterprise system. The problem is with non-profit organizations in business compeating with tax paying companies. It is blatantly unfair, unnecessary, and un-American. Competition is good for everyone, but keep it fair. Lets play with the same rules for everyone in the same field.

Our problem is with the Savannah Speech and Hearing dispensing hearing aids. They make a profit on each aid they sell. They duplicate existing services provided by businesses and exploit their "non-profit" status. If they wish to sell hearing aids then they should be held accountable to the same rules. If they want to provide a community service let them provide hearing aids to indigents at cost. But as it is they exploit their "Goodwill" connection as though they provide good hearted services at cost and use this as an excuse for poor business practices.

We are not asking for you to restrict competition but to make it fair. We are not asking for special treatment, but to be treated equally. We are not asking you to hurt the public by removing unique and vital services but to remove inequities that mislead the public.

I trust in your judgement of fairness.

Sincerely,
Richard B. Pitt
Richard Pitt, BC-HIS

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ODESSA, TEXAS 79761
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CURT AND PEGGY WALLIS
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WHEN A HEARING
AID WILL HELP

June 16, 1987

To All Concerned With The Hearing On Commercial Activities Conducted By Tax-Exempt Organizations:

The Oversight Sub-committee of the House Ways and Means Committee has scheduled three days of hearings beginning on June 22 on Unrelated Business Income Tax of "non-profit" organizations. The UBIT was established in 1950 as Treasury regulations note, "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete". UBIT enforcement is marginal, and IRS is equally inadequate in taxing the unrelated income of these tax exempt groups.

Last year, delegates to the White House Conference on Small Business ranked the problem of unfair competition by tax-exempt groups as third in importance to small-business concerns.

In Odessa, Texas Permian Basin Rehabilitation Center is in direct competition with private hearing aid businesses. They charge for hearing examinations and regular service as well as competitive prices for hearing aids. They also sell hearing aids to wealthy people. According to "The Hearing Journal", May 1987 issue, over 76% of Rehab's gross receipts in 1983 was from sales.

Our office has two very wealthy clients who purchased hearing aids from Rehab. After paying for the hearing test, hearing aids, etc., they found they did not save much money. When they needed service appointments were sometimes scheduled weeks in advance, and they were charged for the service they received. Consequently, they returned to our office to purchase quality instruments. Also, they knew that all examinations and services would be free. They like getting service the same day they have a problem, too.

If Rehab Centers are non-profit and are in fact, funded by "our" tax dollars, they should not be in competition with private businesses. If they want to be "profit" businesses, they should not receive government funding (tax dollars which are taken from the private businesses that are in competition with them). And, they SHOULD NOT hide behind the facade of "helping the poor".

Sincerely,

Curt Wallis
Josh Villasenor
Peggy Wallis
Karen W. Villasenor
J. Michael Wallis

Beltone Hearing Aid Service and Odessa Hearing Aid Center
Certified Hearing Aid Audiologists: Curt Wallis, Peggy J. Wallis, Mike Wallis, Josh Villasenor, and Karen W. Villasenor

Bethlehem Hearing Aid Center
"CONCERNED FOR THE HEARING IMPAIRED".
20 EAST BROAD ST.
BETHLEHEM, PA 18018
(215) 691-2722

July 7, 1987

Robert J. Leonard, Chief Counsel
Ways and Means Committee
U.S. House of Representatives
Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Leonard:

It has come to my attention that there will be Congressional hearings concerning tax-exempt (non-profit) organizations engaging in commercial enterprises. I am a dealer in the hearing aid industry which is a perfect example of these unfair practices. I can only exrpess how pleased I am that there is now some recognition of a situation which has been a personal problem for some time.

Mine is a service-oriented business within a free enterprise system. This currently places me in an awkward position as my business is in competition with hospitals with whom I can't compete. What is worse, I am paying for this non-profit competitor through my tax dollars.

There is a local hospital in particular that my business must run up against and my frustration continues to grow. Not only do I lose the profits, but the hospital's wearers come to my place of business for service and instruction. We do not as a rule charge for these things. The result is that I am now paying to maintain hearing aids that I never sold and my staff spends valuable time with people that are not our customers.

I feel that legislation is very important to maintain a status quo within the system which allows for a truly open and fair market. All dealers have a right to free enterprise practices within their industry. The people who staff my office also have rights. It is not fair for them to service people who may be costing them a job.

I would hope that our legislators can see the importance of restricting unfair competition and respond in kind with a lawful solution to this situation.

I do appreciate any efforts being made and give my full support to whatever needs to be done in rectifying the matter.

Please fell free to contact my office at any time.
Thank you.

Sincerely yours,

Thomas R. Stephens
Hearing Aid Dealer
& Taxpayer

BUSINESSES & ASSOCIATIONS FOR A STRONG ECONOMY
P.O. Box 20171 • Lansing, Michigan 48901 • (517) 374-0860

June 23, 1987

To Whom It May Concern:

BASE gives authorization for the release of the enclosed documentation for use on legislative action for the House Ways and Means Committee on the "Unrelated Business Income Tax Issue."

Sincerely,

Martha A. Andrews

Martha A. Andrews
President

BASE

INDEX

I. BASE (Businesses and Associations for a Strong Economy)

II. Overall Problem Re: Unfair Competition with Non-Profits

III. Government Agencies

- A. Department of Corrections - Prison Industries
- B. State Goverment - Printing
- C. State Government - Personnel Services
- D. Department of Natural Resources - Golf Courses and Campgrounds
- E. State Government - Aerial Photography & Mapping
- F. Department of Transportation - Roadbuilders
- G. Postal Services/U.S. Army - Rubber Stamps
- H. Libraries - Video Rentals

IV. Universities

- A. Computers
- B. Film Industry
- C. Optometry
- D. Medical Clinics
- E. Hearing Aid Sales
- F. Hotel
- G. Travel Agency
- H. Marketing
- I. Golf Courses (also relates to Government re: Dept. of Natural Resources)
- J. Engineering Consulting

V. Miscellaneous - Non-Profits

- A. Humane Society - Veterinary Medicine
- B. Hospitals - Various
- C. Churches - Oriental Rugs

BASE RESOLUTION SUPPORTING FREE ENTERPRISE

RESOLVED that B.A.S.E. (Businesses and Associations for a Strong Economy) encourage and support legislative and regulatory initiatives to prohibit state and local governmental agencies and public institutions from providing goods and services that restrict private enterprise and the creation of jobs in the private sector.

Statement about the resolution

When an agency of the government, a non profit organization or a publicly supported college or university directly competes with private enterprise, economic growth in the private sector is restricted. To insure a positive economic future in Michigan, jobs in the private sector must be created, not destroyed. When tax exempt agencies replace tax paying businesses, not only is tax revenue lost but there is a drain on unemployment compensation and public assistance. Prison industries must not compete with the private sector to a point where the very jobs prisoners are trained for are no longer available.

For the well being of the economy of our state it is imperative we enact legislation to prohibit unnecessary competition from tax supported agencies with private enterprise that undermine the principles of free enterprise.

As a business/association that supports the principles of
free enterprise we endorse this resolution.

____
(name of business or association)

Official of the Organization ______________________________
(print name)

____
(title)

____
(signature)

BUSINESS ASSOCIATED FOR A STRONG ECONOMY
P.O. Box 20171
Lansing, Michigan 48901

SUMMARY OF ACTIVITIES

BASE (Businesses Associated for a Strong Economy) was founded in the Spring of 1982. Martha Andrews of Mid-Michigan Stamps and Signs was elected Chairman of the group.

Representatives of the printing, veterinary medicine, construction, aerial surveying, professional engineering, architects, surveyors, and other industries have met to describe the problems caused by the unfair competition of the state government against small, private enterprises. From the descriptions of the problems, a policy statement for the BASE group was written, copy attached. Letters were sent to representatives of many industries through their associations to garner support and interest in the issue of unfair government competition.

Monthly meetings were held at which representatives of the varying industries affected were updated on progress toward a resolution of the problem. Martha Andrews, Michael West, of the Michigan Plumbing and Mechanical Contractors Association, and Dr. Knirk of the Veterinary Association, met with the issues Committee of the Michigan Republican Party on three occasions to make the Republican Party aware of the problem.

In the Fall of 1982, and the Winter of 1983, various legislators were invited to the meeting of BASE and made aware of the issues. Included were Representatives Debbie Stabenow and Paul Hillegonds and State Senator William Sederburg. Several bills have been proposed as a result of meetings with these legislators.

In the Spring of 1981, the National Federation of Small Business and the Michigan State Chamber of Commerce began to show interest in the issue of unfair government competition with private enterprise. Representatives of both of these groups are now meeting on a regular basis with BASE.

In January of 1983, Martha Andrews, Carolyn Domagalski, Steve Wagner of the Professional Engineers and Steve Vermillion of the Associated General Contractors, attended a meeting of the Civil Service Commission to discuss the issue. They became aware of certain problems presented by radical and vocal Civil Service workers.

In March of 1983, members of BASE met with Representative Stabenow and Lieutenant Governor Martha Griffiths to discuss the issues.

Interest has been shown all along the line because of the severe economic status of the Michigan State government. In all cases, representatives of BASE have proposed the concept that if the state government would cease from competing with private enterprise, revenues to the state would increase while expenses would decrease.

Among the issues now being tackled are the ways to define unfair competition from the state government while encouraging government to work in more efficient and effective ways in all aspects of their business affairs assuming responsibility for those areas of service that can be done most efficiently within the government framework itself. Where efficiency cannot be met and proven, the private sector should be made responsible for supplying the state government with it's needed goods and services.

BASE

Corrected Copy 4-21-83

BUSINESS ASSOCIATED FOR A STRONG ECONOMY
P.O. Box 20171
Lansing, Michigan 48901

December 1985

We have sent this letter to all the colleges & universities in Michig There has been no reply!

Dr. C. Robert Bennett
President
Gogebic Community College
E-4946 Jackson Rd.
Ironwood, MI 49938

I am writing you as . . .

. . .chairperson of Business Associated for a Strong Economy (BASE), which is an association of business interests united by a strong concern regarding government and non-profit competition with the private sector.

BASE was founded in 1982 because businesses were, and are, losing income to some governmental agencies and non-profit organizations. These groups pay no taxes and in the case of government agencies, their budgets partially underwritten by taxes drawn from the private sector.

We are specifically concerned about situations that have been brought to our attention regarding possible competition between small business and our universities. As public policies change and universities change to meet public needs and demands, we are concerned that our policy makers evaluate the full impact of decisions to allow university departments to contact with private individuals for goods and services or decisions to provide needed services "in house" instead of contracting with the private sector.

To that end, we are interested in communicating with you or your staff as situations arise that are received as potentially unfair competition with Michigan businesses. We believe this is best done as specific decisions are being made and that it would be most helpful if Gogebic Community College had an office and/or person designated as the Business Ombudsman for the University. This office could be advertised as the place to call if businesses have questions or concerns and we could communicate directly with this office as situations are brought to our attention.

BASE sincerely believes that communication is the key to resolving any unfair competition--whether real or perceived. We realize we have a high quality university system in our State and we are interested in maintaining and improving our economic base so that our public services can be adequately funded. To achieve this, we believe the private sector must be allowed to grow without unfair competition from the public sector.

We would greatly appreciate your response to our request and we look forward to a positive working relationship.

BASE

Sincerely,

Marty Andrews

Marty Andrews
Chairperson
Business Associated for a Strong Economy

1973

DOCUMENTATION OF THE PERILS OF STATE GOVERNMENT COMPETING AGAINST THE PRIVATE SECTOR IN MICHIGAN.

GENERAL STATEMENT:

There is a growing trend in the State of Michigan for various departments of the state government to take over and increase various services which, traditionally, have been provided adequately by the private sector. Often, the department heads initiate these programs with good intentions. It is becoming increasingly clear, however, that there is a lack of regard for some severe consequences of this growing trend.

THE PERIL:

When the state government replaces private industry in providing products and services, as is occuring with more frequency, several things happen:

1. Jobs are lost from the private sector with the following consequences:
   a. Loss of income tax generated. (While state government employees pay income tax, it is, in fact, a repayment of a portion of the tax money used to pay their salaries, expenses, and benefits.)
   b. Increased drain on unemployment compensation and welfare program funds.
   c. Loss from the state of skilled and expert laborers, technicians and decision makers who move to other states.
   D. Loss of investment capital to other states.
   e. Increase in crime due to joblessness.
2. An increase in the state government expense budget for increased personnel to provide the products and services causing the need for higher taxes or greater borrowing to balance the state government budget.
3. While there is an overall increase in the expenditure of tax money, there is a corresponding decrease in the generation of tax money.
4. Creation of a false sense of benefit for the citizens of Michigan, by indirect government subsidization of major cost factors, thus lowering "selling prices."
   a. Interdepartmental "profits" within state government based on labor and materials, omitting the following unavoidable expenses in providing any product and services.
      I. Administration
      II. Property purchase and property taxes
      III. Building construction
      IV. Maintenance
      V. Supply
      VI. Heating and cooling
      VII. Research and development
      VIII. Sales
      IX. Marketing
      X. Water, Water Heating, Water Supply
      XI. Waste Disposal

   b. Loss of revenues from lost property taxes, Single Business Tax, corporate income tax and tax revenue of indirect, supportive industries which develop as a result of private enterprise.

   c. Loss of most efficient cost/price because of loss of competition.

   d. Increased expense due to state government's built-in higher cost

5. The beginning of "empire building" by functions within departments which begin to look for ways to be self-perptuating as well as increasing in scope, variety, power and influence, even if benefits of service are not verified.

SUMMATION:

The state government does not and cannot exist and grow without a healthy, free enterprise economy. The economy of Michigan cannot be healthy if the state government continues to take away the opportunity for jubs and free enterprise and, thus, tax-generating activities which are the sole support of the state government. If it gets to the point where the state government is providing so many products and services that the tax base and welfare programs in the state increase any further, when they should be decreasing, the state will not be able to compete with neighboring states and will face outright economic failure.

Following are examples of areas where the state is infringing on the opportunities and abilities of the private sector to perform its beneficial services for the citizenry of our state:

1. Engineering and professional design in transportation and Michigan's natural resources.

2. Land surveying.

3. Temporary office personnel service.

4. Typesetting and printing, either inhouse or with the requirement that competitive bids be let only to companies whose employees are unionized.

5. Sign making, printing, and painting as performed by state government departments and state-subsidized units such as state universities, high schools, state hospitals, etc.

6. Engineering research for transportation and railway systems as performed by state-supported educational institutions.

7. Manufacture of clothing, office furniture, printing and signs, as performed by Michigan prison industries.

8. Replacement of light bulbs and water heaters, etc., and installation of insulation and gas piping as performed by state regulated utilities.

9. Performance of animal and pet care as veterinary medicine services open fos all public consumption as performed by tax-exempt humane societies.

10. Imposition of restrictions on companies eligible to perform bidding and supply of products and services to the state government because of a srtctly arbitrary exclusion of the majority of tax paying companies and citizens of the State of Michigan.

11. Manufacture of metal cabinets for office filing and storage.

1975

Non-profits edging into competition with private firms

Small private firms, which must pay a variety of state, federal and local taxes as a cost of doing business, are finding it more and more difficult to compete as a growing number of tax-exempt, non-profit organizations move into for-profit activities.

According to the U.S. Small Business Administration's Office of Advocacy, competition between nonprofits and for-profits is occurring in traditional service industries such as merchandise sales, health care and travel. It is also occurring in newer fields such as laboratory testing, audio-visual services, engineering consulting, data processing and computer software production and sales.

In Michigan, a number of veterinarians are in danger of being put out of business because the Humane Society and other similar taxpayer supported groups are establishing full-service practices, according to Dr. Peter Prescott, president and executive director of the Michigan Veterinary Medical Association.

Because they are tax-exempt and receive some funding from state and federal governments, the humane societies have considerable business advantages over private veterinarians, Prescott said. In addition, they enjoy a great deal of media exposure while private veterinarians must pay to advertise their services.

The problem is especially acute in southeast Michigan, where some veterinarians are losing business at a rapid rate, Prescott said.

Providing free or lost-cost health care for animals is not an entirely new activity of the humane societies. They have traditionally provided a limited amount of service to people in poor, low-income areas. In fact, most private veterinarians have supported these efforts in the past, Prescott pointed out.

The difference now is that the tax-exempt non-profit agencies such as the humane societies are commercializing their services in order to generate revenue for the non-profit association. They are moving into nicer, more affluent neighborhoods, where they are directly competing with private veterinary practices.

Prescott said that the Michigan Veterinary Medical Association is working with the SBA on this problem. The group has also begun to meet with Business Associations for a Strong Economy (BASE), a statewide organization which is attempting to gain legislative reforms aimed at decreasing the amount of government competition with private industries.

Competition for Federal Funds

The increase in competition from nonprofit firms is largely due to the explosive growth in the number of these firms in recent years. According to the Office of Advocacy, there are now more than one million nonprofit firms in this country. By 1980 it was estimated that these firms accounted for approximately 5.5 percent of the gross national product.

In addition, nonprofit activities are concentrated in a relatively few industries which employ large numbers of persons, such as research, health care and education.

Advocacy points out that most nonprofit organizations are engaged in educational, research and charitable activities that provide a legitimate basis for their tax-exempt status under federal and state corporate income tax laws.

The problem arises when these organizations launch business enterprises that are unrelated or only tangentially related to their tax-exempt purpose in order to increase operating revenues. Generation of such "non-program" revenue as merchandise and travel tour sales is considered to be unfair to small firms which pay a myriad of federal, state and local taxes to conduct business.

A three-year project, launched by the Urban Institute in 1982 to examine the scope and operations of the nonprofit sector, found that two-thirds of the nonprofits were formed during the past 20 years. Fifty percent of these organizations expected to increase their income from the sales of goods and services in the next year, the report said.

Revenue reports show that nonprofits are relying increasingly on earned income as a source of operating revenue. Independent Sector, an association of nonprofit entities and major donor organizations, reports that from 1974 to 1980 total nonprofits' income from dues, fees and charges more than doubled. (From $29.2 billion to $61.7 billion)

Re-examining Policy

While there are currently provisions in the tax code that are designed to tax the "unrelated" or non-program revenue of nonprofits, these provisions are diluted by numerous legal ambiguities and overly broad exceptions, advocacy reports state. Because of this, very little tax revenue has been collected under these provisions.

Advocacy urges that representatives of the non-profit and small business communities begin a dialog to explore ways to eliminate, or at least ameliorate, unfair competition where it occurs.

Frank Swain, Chief Counsel for Advocacy, participates in regular meetings between representatives of the university community and small firms experiencing competition from faculty who offer outside consulting services using university facilities and personnel. Another issue under discussion is that of equipment, acquired through federal grants for basic research, being used for commercial-type services to the surrounding business community.

For more information on this topic, contact Frank Swain, Chief Counsel for Advocacy, U.S. Small Business Administration, Room 1012, 1441 L Street, N.W., Washington, D.C. ✿

Small private firms are fighting back

The owner of a successful small firm which makes stamps and signs, **Martha Andrews** became quite concerned when she noticed a sudden slowdown in business. When she discovered that she was losing business to such taxpayer-supported entities as state prisons, public universities and the state highway department, she decided to do something about the situation.

In the spring of 1982, Andrews contacted 14 associations, asking them to attend a meeting in Lansing about the growing trend toward government competition with private industry. This was the start of BASE — Business Associations for a Strong Economy, a statewide organization which has been working to curb unfair competition from taxpayer-supported agencies.

Andrews found that her feelings about government duplication of services, which were already being provided by the private sector — often at a lower cost — were shared by a large number of people throughout Michigan. The mailing list for BASE today includes 150 associations and individuals.

The growing frustrations which led Andrews to form BASE are probably similar to those experienced by many owners of small to medium sized businesses. Andrews was getting contracts from the state to make such items as badges and highway signs for several years. When business began dropping off, she found it was because the state was having the jobs done by state agencies. She also discovered that these items were costing the state twice as much money to be developed in-house at a much slower rate of production.

"I was very irate," Andrews recalls. "I was upset about my loss but mainly I was angry about tax dollars floating down the drain."

She got even angrier when she was approached by an employee of the state highway department who wanted to know how Andrews manufactured her signs. The man told her that the highway department was going to buy equipment and make its own signs. Andrews never got another contact from the department.

The first attempts Andrews made to get assistance from the governor's office on this issue were unsuccessful. In fact, she was told by one public official that nothing could be done, that "mom and pop" businesses were on their way out of existence.

It was at this point that Andrews began contacting other associations and formed BASE.

Martha Andrews

Much of BASE's work is aimed at reforming legislation and state government policies to prevent duplication of services and unnecessary taxpayer expense. Among the representatives who have written bills in support of this effort are Representative **Paul Hillegonds** (R-Holland), Representative **Thomas Mathieu** (D-Grand Rapids), Senator **William Sederburg** (R-East Lansing) and Rep. **Debbie Stabenow** (D-Lansing).

As a result of these efforts, Public Act 15 was passed Feb 29, 1984. Due to this measure, the state government has been monitoring state agencies to determine areas where services can be more cost-effective if they are leased out to private firms rather than handled in-house.

Herb DeYoung, of the Michigan Department of Management and Budget, explained that the state is pursuing this effort on a continual basis. Each state department head has been directed to look at those activities which could possibly be done by the private sector and make these recommendations in their budget reports, DeYoung said.

Some work which the state of Michigan has already begun leasing out to private companies includes janitorial services, temporary office help, drug packaging and architectural and engineering services.

Persons who are interested in joining BASE, or who would like more information about the issue of government competition with the private sector, are encouraged to contact Martha Andrews, 400 N. Larch St., Lansing, MI 48912, or P.O. Box 20171, Lansing, 48910. ✿

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*** IMPORTANT NEWS ***
BASE IS MAKING PROGRESS

UNIVERSITY BIDDING UPDATE

Unfair competition of colleges and universities with the private sector has been one of the primary areas of concern and discussion for B.A.S.E. members. Several examples of unfair university competition have involved the policies and procedures of the Department of Management and Budget which allow colleges and universities to submit bids and compete with small business persons for state contracts. The university is often awarded the bid since they do not have to include their overhead costs as part of their proposal. The business person does not have this advantage.

In response to pressures by small businesses affected by the state's bidding procedures and concerns raised by B.A.S.E., the Department of Management and Budget has issued a new policy which is intended to limit the bidding process for colleges and universities to make the awarding of contracts fairer for small business. This administrative policy directs the Department to solicit bids from colleges and universities only if the service can be provided solely by an educational institution. If the service is provided in the private sector, bids are solicited only from the private sector. The written policy states:

> "Educational or governmental services are defined as those that can only be acquired through educational or other governmental entities because of the unavailability of such services from the private sector. These services would be limited to programmatically-related research, scientific, educational or governmental programs which are directly linked to the State's service needs." - Administrative Manual, Department of Management and Budget, 8-2-1.

Although this policy change has not remedied every instance of college and university bidding, unfair competition has been greatly reduced. Thanks to the Department of Management and Budget for trying to address our concerns and thanks to all small business persons whose persistence and patience helped bring about this change!!

**** Issued by Rep. Stabenow's Office

PRISON COMMITTEE UPDATE

The Market Survey Committee and New Product Committee are studying various aspects of the Michigan State Industries (MSI) operation, and will make recommendations to the full Advisory Conuncil. At the last meeting of the full Council, members acepted a Market Survey Committee recommendation that the Department of Corrections be asked to retain the services of a professional consultant. The consultant would develop a comprehensive marketing plan for MSI and complete an in-depth survey of state government purchasers of MSI products. The survey will provide valuable information on the quality of MSI products and services--as well as ideas for products MSI could produce but currently doesn't.

The New Product Committee is focusing on the policy issues that must be addressed when MSI proposes to bring a new product to market. This committee is particularly concerned that the issue of competition with the private sector be formally addressed before a decision to create a new product line is finalized. The committee is in the process of developing information on products not currently made in Michigan -- and preferably the United States.

**** Issued by Paul Smyth, Department of Commerce

Private sector expresses concern about impacts of government competition

There is an increasing concern among owners of small business in Michigan and across the country about what they see as a growing trend toward government competition with private industry.

Many companies are finding the demand for their products and services lowered due to direct competition from state and federal governments as well as taxpayer-supported agencies, including universities, state hospitals and prisons.

A group of concerned business people in Michigan have formed Business Associations for a Strong Economy (BASE), in an effort to return the production of goods and services to the private sector.

BASE includes such groups as the Michigan Manufacturers Association, the Michigan Retailers Association, the Society of Consulting Engineers, architectural associations and many individual small business owners who have been directly impacted by government competition.

When governmental and taxpayer-supported agencies sell their goods and services to the general public, a loss of private sector jobs results, members of BASE contend. The consequence of these job losses can have severe impacts on the state's economy, including:

- Loss of income tax generated. (While state government employees pay income tax, it is, in fact, a repayment of a portion of the tax money used to pay their salaries, expenses, and benefits.)
- Increased drain on unemployment compensation and welfare program funds.
- Loss from the state of skilled and expert laborers, technicians and decision makers who move to other states.
- Loss of investment capital to other states.
- Increase in crime due to joblessness.

In some cases, government agencies are able to sell their products at a lower price because the true costs of production are being subsidized by tax dollars, business owners in the private sector charge.

Large utility companies are a case in point. In many parts of the country, regulated utilities are entering into competition with small businesses in unregulated markets, providing maintenance contracts for residential users at a substantially lower price than small businesses must charge. This is possible because the utility rate payers are underwriting the utility costs not recovered from the customers with maintenance contracts.

In other areas, such as services sold by universities or products made in prisons, government agencies are able to show a profit simply because they omit various unavoidable business expenses, including:

- administration
- property purchase and property taxes
- building construction
- maintenance
- supply
- heating and cooling
- research and development
- sales
- marketing
- water, water heating, water supply
- waste disposal

Additional losses to the state which result from government competition with private industry include a loss in revenue from property taxes, the Single Business Tax and tax revenues from indirect, supportive industries which develop as a result of private enterprise.

As government products and services replace those provided by the private sector and private firms are forced out of business there will be no incentive to develop items at the most efficient cost because open competition will have ceased, private sector business people say.

A final concern is that government production of goods and services will result in "empire building", with departments looking for ways to be self-perpetuating and increase their scope, variety, power and influence.

Areas where the state is seen to be infringing on the opportunities and abilities of the private sector to perform its services include:

1. Engineering and professional design in transportation and Michigan's natural resources.
2. Land surveying.
3. Temporary office personnel service.
4. Typesetting and printing, either in-house or with the requirement that competitive bids be let only to companies whose employees are unionized.
5. Sign making, printing, and painting as performed by state government departments and state-subsidized units such as state universities, high schools, state hospitals, etc.
6. Engineering research for transportation and railway systems as performed by state-supported educational institutions.
7. Manufacture of clothing, office furniture, printing and signs, as performed by Michigan prison industries.
8. Replacement of light bulbs and water heaters, etc., and installation of insulation and gas piping as performed by state regulated utilities.
9. Performance of animal and pet care as veterinary medicine services open for all public consumption as performed by tax-exempt humane societies.
10. Imposition of restrictions on companies eligible to perform bidding and supply of products and services to the state government because of a strictly arbitrary exclusion of the majority of tax paying companies and citizens of the State of Michigan.
11. Manufacture of metal cabinets for office filing and storage.

Next month: A closer look at utility competition and some examples of small businesses in Michigan which have been impacted by government competition. ☆

[illegible]

The Oakland Press
11-25-83

Vern Tessier
Rochester 48063

Oakland Press 11-25-83

Others cry foul

Non-profit firms use advantages

The Associated Press

WASHINGTON — Small businesses are complaining about the unfair competition they say they run up against when non-profit organizations turn their substantial tax breaks into lower prices for their services.

"It's a serious problem," says Charles Garber, president of Structure Probe Inc., a research services laboratory in West Chester, Pa., that finds some of its toughest competition coming from universities.

The Small Business Administration, in a recent report, says the problem is growing as universities, research institutes, hospitals, nursing homes, vocational schools and other non-profit organizations turn more to commercial activities to supplement their operations.

The commercial activities, too, are expanding from the traditional areas of travel, merchandise sales and health care into laboratory testing, audio-visual, engineering consulting and data processing services.

"Non-profit firms, particularly the commercial non-profits, are now competing head-on with for-profit firms in many areas of activity. Moreover, these non-profits are coming to resemble their for-profit competitors in structure and operation," the report says.

In an interview, Frank Swain, the chief counsel for advocacy of the Small Business Administration, said, "I don't think any small business minds competing with other businesses under the same terms."

But small businesses say they aren't on the same footing when it comes to tax breaks, benefiting from federal grants and sharing federal contracts.

Non-profit groups can use these breaks to offer better prices than their private competitors, who say their costs are much higher.

"Out-of-state school districts that become MECC members receive substantial discounts on computer software purchases that for-profit producers of these materials cannot match. It is estimated that ... it controls approximately 20 percent of the marketplace for classroom computer software outside of Minnesota," the report says.

The major advantage non-profit organizations have over private firms is exemption from federal corporate income tax.

The Internal Revenue Code does not prohibit those groups from offering commercial services and sets out an "unrelated business income" tax for any business activities.

But the SBA report said the unrelated business tax is ambiguous and provides "overly broad exceptions." Total collections under that tax amounted to $31.6 million in fiscal 1982.

To correct the problem, the report recommends several ways to change the tax law so that non-profit organizations are discouraged from going into profit-making areas.

1979

D&B Reports from Washington

Promoting the private sector

by Hugh C. Newton

Government will never go out of business, but it may *get* out of business if certain Reagan administration spokesmen have their way.

Their strategy is called "privatization": stopping unnecessary government competition with the private sector.

Already, there is plenty of cause for concern among small business owners. Office of Management and Budget Director David Stockman estimates that government uses more than $40 billion, equally divided between capital and operating costs, to perform services and manufacture products already provided by the private sector. A recent study by the Government Accounting Office reports that 400,000 federal employees currently operate more than 11,000 commercial or industrial activities, most of which are or can be provided cheaper by American business. Furthermore, the nature of these 11,000 federal enterprises indicates that most of the services, were they contracted out, would be performed by medium and small businesses.

Promoting the private sector

Between OMB, Housing and Urban Development and other agencies, the Reagan administration is making a concerted effort to transfer government services to private sector contractors. Their logic asks why government should penalize businesses with high taxes and high levels of spending when, instead, government itself could do less and business do more, creating jobs and increasing efficiency.

Experience seems to support the administration's position. Stockman, testifying before the Joint Economic Committee hearing on the impact of government competition on small business, cited 440 cost studies conducted by the Defense Department over three years. In 60 percent of those cases, the three military services decided to work through private contractors and thus created 11,000 full-time private sector jobs. Also, the General Services Administration discovered that if it had contracted for its janitorial needs, $16 million could have been saved in 1980.

On a federal level, the initiative comes with the administration's attempt to toughen OMB specifications, originally published in 1979, to promote the use of private sector contractors. The Stockman revisions require agencies to undertake extensive cost analyses to determine what services should be diverted to private sector contractors, establish tough guidelines dictating how the analyses should be performed, and require all expired contracts to be reviewed to determine cost-effectiveness.

To clarify and underline these proposals, Rep. David Drier and Sen. S. I. Hayakawa, both of California, have introduced legislation.

Cracking down on federal agencies represents only a part of the overall strategy for privatization. On the cutting edge of local and state initiatives is Dr. E. S. Savas, assistant secretary for policy research and development for the Department of Housing and Urban Development.

Getting more for less

In recent testimony before the Subcommittee on Intergovernmental Relations of the Senate Governmental Affairs Committee, Savas criticized a Joint Economic Committee survey of 275 cities showing grossly unbalanced budgets and large operating deficits. Strongly disagreeing with that bleak assessment, Savas claimed that privatization can push many cities back into the black, using private contractors to provide what were, formerly, public sector services in such areas as water supply, sewage treatment, jails, police communications, libraries, animal control, resource recovery plants, public works, recreation and education.

Savas said, "Cities have found they can reduce costs 20 to 30 percent and improve service delivery by prudently contracting out some of their services to the private sector," adding that of 2,375 cities with populations over 2,500, 21 percent already use private firms for refuse collection and 13 percent contract out for street repairs. Savas also suggests local franchising for such things as telephone and bus services grant systems—either as direct grants or as tax-exempt status—for low-cost housin or mass transit; vouchers for educational tuition; and reliance upon purely charitable private sector initiatives for some community work.

Such alternatives to public sector services, said Savas, increase efficiency, decrease vulnerability to contractor failures and employee strikes, and offer an effectiv means of comparing the two methods of service.

Clearly, Savas' drive for local privatizatio may be greatly enhanced by the passage o the Reagan administration's so-called "Nev Federalism" program, shifting 40 or so federal programs to state control and state funding over the next decade. In any even both cities and small businesses could come out ahead. In the area of refuse collection in New York City alone, says Savas, privatization could save city coffers $75 million a year, while providing jobs, profit and opportunity for entrepreneurs and local residents.

Technology wars

It seems more like an Agatha Christie murder mystery than small business legislatio A group of alleged small business owners attempt to kill a small business bill, while other small business groups, supporting th bill, contend that the opposition is really bi business dressed up in small businesses clothing.

> **"Cities have found they can reduce costs 20 to 30 percent by prudently contracting out some of their services to the private sector."**

The fight surrounded H.R. 4326, a bill which guarantees that a small percent of all federal research and development money goes to small business. Supporting the bill is the Small Business Administration and virtually every small business organization in Washington; opposing it is the American Electronics Association (AEA), which claims to represent most of the small businesses engaged in research and development.

Ken Haggerty, vice president for governmental affairs of the AEA, led the opposition, claiming that earmarking R&D funds for small business would create "bandit" small businesses which would only exist for handouts. Also, he said, pressures would force agencies to waste money simply to fulfill the quotas.

Spokesmen for the National Federation of Independent Business (NFIB) and other small business groups contend that such earmarking is only logical, since government figures show that huge proportions of innovation and invention come from the small business sector, and because small businesses are considerably more efficient, dollar for dollar, at excelling in R&D. Speakers for some of the groups argued that those opposed to the bill were universities and big businesses unwilling to see any of "their" R&D funds siphoned off to smaller firms.

A *Washington Post* editorial agreed with the AEA in opposing the Small Business Research and Innovation Act, and drew fire in a counter-editorial jointly written by the bill's Senate sponsors, Senators Weicker (R.-Conn.), Rudman (D-N.H.) and Kennedy (D-Mass.), who charged that the AEA "is dominated by giant corporations such as Xerox, Lockheed, Hewlett-Packard and Litton Industries. Of the 23 companies that make up its two key governmental affairs committees, 16 are traded on the New York Stock Exchange, two on the American Stock Exchange and one over the counter. The association never polled its membership [illegible] in fact, a significant number of its small business members have already joined the overwhelming majority of small business groups supporting the legislation." Among those opposing the AEA is the Electronics Association of California, composed of 400 small and medium-sized high-tech firms, who contend that "there is no issue of more importance to the long-range economic and defense strengths of the U.S."

Consequently, the Senate version passed by 90 votes to zero. In the House, the bill has been reported out of all six committees, each with different amendments. Most amendments attempt to exempt certain government operations from the bill, but virtually all small business organizations oppose agency exemptions which drastically sap the strength of the legislation. Presently the House leadership has delayed the bill, which must pass through the Rules Committee before the various amendments can be reconciled on the floor of the House.

Half price special

Take two aspirins, sit down, and brace yourself. If you are an average American worker, last year you toiled until May 11th to pay the government's share of your earnings. Beyond the direct costs of taxation, indirect costs are equally significant.

Price increases resulting from federal regulations cost you an additional $500 a year, and the costs of federal paperwork are estimated at $500 per person per year. If you bought a car, the automobile regulations imposed from 1968 to 1978 raised your costs by nearly $700.

If that doesn't bother you, the *Federal Register* cites existing government regulations dictating the shape of toilet seats, the way stepladders may be climbed, and the size of knotholes permissible in wood used to build the ladders.

This cheerful information comes from James Bennett and Manual Johnson, economics professors at Virginia's George Mason University. Fortunately, their book, *Better Government at Half the Price*, investigates solutions as well as problems, focusing on privatization, why bureaucracies are doomed to inefficiency and waste, and what went wrong with government procurement practices.

The book also gives an interesting perspective on the power shift from state to federal government: "In 1929, out of each 8-hour day, the typical worker spent 19 minutes paying his federal tax bill and 33 minutes working for state and local governments. Today this is reversed. Only 58 minutes of each 8-hour day are devoted to paying state and local taxes, but one hour and 47 minutes must be worked to satisfy the federal tax collector."

This book, with a preface by William Simon and illustrated by the sardonic cartoons of Jeff MacNelly, is available for $5.95 by writing to Caroline House Publishers, Box 738, Ottawa, Illinois, 61350. ■

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Small Businesses Seek Laws to Bar Competition from Tax-Exempt Organizations

WASHINGTON

The White House Conference on Small Business last month called on Congress and the state legislatures to consider prohibiting tax-exempt organizations from competing with private businesses and to review the criteria for awarding tax exemptions.

The resolution received the third highest level of support of the 60 resolutions approved by the 1,600 delegates—small-business owners from across the country—attending the conference. Only resolutions calling for reform of liability-insurance laws and for the government not to require new employee benefits received more votes.

The action by the White House Conference was the latest in a series of efforts by organizations representing small businesses to persuade the federal and state governments to eliminate what the businesses say are unfair advantages enjoyed by tax-exempt groups.

For colleges and universities, many of which have expanded their business operations in recent years, the issue could be the next major threat to their status under federal tax law. Higher-education organizations, bitterly disappointed by the tax plan approved by a Congressional conference committee last month, are already voicing their opposition to the business proposals.

Dole Supports Businesses

The college and university activities that draw the most criticism from business leaders are discount sales of computers, technical consulting services, sales of clothing, and food-service operations available to non-students.

Several states have already adopted laws limiting such activities, and legislative committees in other states are studying the issue (*The Chronicle*, April 16).

U.S. Senate Majority Leader Robert J. Dole told the White House Conference that he supported their call for new legislation. "You ought to be protected from so-called charitable groups that are really trying to make a profit," said Mr. Dole, a Kansas Republican.

In the U.S. House of Representatives, the Subcommittee on Oversight of the Ways and Means Committee is studying the ways in which small businesses are affected by the business activities of non-profit organizations. The subcommittee is also examining possible changes in the laws governing tax exemptions.

A subcommittee aide said the panel would be calling on interested parties to submit information this fall.

No legislation is expected before 1987, at the earliest.

Joseph F. O'Neil, chairman of the Business Coalition for Fair Competition, said small-business owners would increase their lobbying efforts in the year ahead.

"It's understandable that colleges and universities have looked to other sources of revenue as the federal dollars have dried up," he said. "But they shouldn't be able to use their tax privileges to do so. The marketplace has become skewed. Non-profits should face the same burdens as small businesses."

Louis F. Moelchert, Jr., who chaired a committee studying the issue for the National Association of College and University Business O ficers, said higher-education group would oppose any new legislatio that would restrict their business ac tivities.

"No one is trying to take advan tage of small business," said Mr Moelchert, vice-president for busi ness and finance at the University o Richmond. "But services that they see as competitive, we see as essential to our students and faculty members."

He said most of the legislation that had been proposed would not be practical, because a college's need for business operations varies depending on the academic programs offered and the services available in the local community.

—SCOTT JASCHIK

BUSINESSES & ASSOCIATIONS FOR A STRONG ECONOMY
P.O. Box 20171 • Lansing, Michigan 48901 • (517) 374-0860

1982

MICHIGAN STATE CHAMBER OF COMMERCE

Issue Paper

PRIVATE ENTERPRISE ACT

WHAT IS THE ISSUE?

The "Private Enterprise Act", when introduced, will aim at controlling competition between the private sector and state government. To achieve this goal it will require that all costs incurred by state agencies be reported and compared with the cost of a product or service provided by business.

WHAT DOES IT MEAN TO BUSINESS?

This bill, if passed and signed into law, will require government to contract out for goods and services from the private sector when such action is cost beneficial. It will result in fewer businesses having to compete with government and will produce more private sector jobs and less "fat" in state government. Additional tax revenues will also be produced by the businesses that secure the contracts.

WHAT IS THE STATE CHAMBER OF COMMERCE DOING?

The State Chamber supports the bill.

The State Chamber of Commerce has and will continue to work with the sponsor, Senator Bill Sederburg (R-Lansing), to introduce the bill and work for its passage. Currently we are compiling information on examples where public vs. private sector competition exists. We need examples of this nature from you.

WHAT ARE THE EXPECTATIONS FOR SUCCESS?

Passage of this bill will be an uphill battle. Certain members of the legislature don't feel small business should have to overcome competiton from government. However, most others aren't convinced of the merits behind this legislation. We will keep you posted on necessary action.

For more information contact PHIL GAJEWSKI, Manager, Small Business Programs at the State Chamber, Suite 400, 200 North Washington Square, Lansing, Mi. 48933. (517) 371-2100.

Competition by state hurts firms, taxpayers

Point of View

By Roger J. Haynes

The author of this commentary is director of governmental relations for the Michigan Chapter, National Federation of Independent Business.

What government practice in Michigan raises public costs, raises taxes, lowers revenues, drives conmpanies elsewhere and damages the state's business climate?

It's called government competition and it's a bane to Michigan taxpayers and small businesses alike.

Government competition exists when a public body or a tax-subsidized non-profit group goes into business against the Main Street shops nearby. Unfortunately, the behemoth usually wins — and wins at everyone else's expense.

Let's look at some examples of government competition supplied by the National Federation of Independent Business/Michigan:

■ Many Michigan colleges and universities make special arrangements with computer vendors and sell computers and software to the general public at prices local computer stores can't match.

■ Michigan prisons manufacture office furniture, signs, even specialty printing with artificially low wage rates and resulting bargain-basement prices.

■ Non-profit humane societies operate clinics that examine pets and give injections at prices that literally drive nearby veterinary hospitals out of business.

■ Department of Natural Resources surveying crews, test drilling rigs and aerial photographers easily underprice private surveyors when competing for business.

■ Public trash haulers frequently ignore many costs and then underbid private competitors.

■ Subsidized Government foster-care centers compete with private providers.

■ High school workshops paying no wages and no over-

head easily undersell local companies.

■ State vocational training centers offer the services of student barbers at $2 per haircut, and student auto mechanics at $6 per oil change.

Many small businesses clearly cannot compete with these subsidized ventures. It drives some companies out of state or even our of business. For others, it lowers their sales volume, their employment opportunities and the taxes they pay to state and local governments.

What's worse, it costs everyone more to subsidize these government services. Taxpayers must pay for salaries (which are often higher than those in the private sector), and pay for workers' compensation, unemployment compensation, pensions, health insurance, liability insurance, and maintenance of facilities and equipment.

Along with government competition comes a larger and more expensive government that runs against national efforts to streamline public functions and reduce taxes.

Government competition is a quandary to Michigan taxpayers. What seems benevolent and harmless really undercuts the business climate and raises taxes for everyone.

It's a double-edged sword that slashes at our economy both ways.

Point of View is a forum of public opinion. If you have expertise and opinions about a matter of public interest and would like to write an essay, contact Bob Stuart, Editorial Page Editor.

Relief efforts praised

Associated Press

YAOUNDE, Cameroon —
well-coordinated relief effo
brought food and shelter Thur
day to those who survived th
lethal gas that burst from a plac
volcanic lake a week ago an
killed more than 1,500 people, o
ficials said.

International teams of scie
tists were inspecting the sce
and interviewing survivors, tryi
to identify the gas or gases a
determine how and why the disa
ter occurred.

Gov. Pai Francis Yengo of th
affected Menchum region is i
charge of the relief operation i
Wum, about 20 miles from the di
aster area around Lake Nios. H
said most victims had been buri
in mass graves and carcasses
dead animals were the ma
health hazard.

In Geneva, the Office of th
U.N. Coordinator for Disaster Re
lief said 5,000 survivors need
help in the volcanic mountains
this West African nation. The In
ternational Red Cross appeal
for at least $300,000 in emergen
aid.

Britain's Foreign Office said
London that a plane would lea
for Yaounde today carryi
$375,500 worth of relief suppli
including food, medicine, ten
children's clothing, cots and bla
kets.

Fear arose immediately aft
the disaster last Thursday th
help would be slow in reachi
the Lake Nios area because
primitive roads and poor comm
nications, but Gov. Yengo said
the state radio Thursday that "a
is not coming too late."

Officials said food, medicin
blankets and mattresses we
being moved to villages from th
provincial capital of Bamend
where two truckloads of food a
rived Thursday morning.

Yengo said most of the hom
less had been housed with rel
tives in nearby towns, or in co
munity centers and schools.

At least 90 nomadic Fulani c
tle herders, who normally wand
the lush mountain pastures, h
arrived at settlements seeki

Edited by Laura Saunders

When so-called nonprofit organizations go into profitable businesses, they can beat up taxpaying competitors.

Profits? Who, me?

ENTREPRENEUR Thomas Inman of Newport News, Va. sank $50,000 into electronic crib monitors in 1980. Inman's small medical supply company, Virginia Home Medical, was going to rent the equipment to parents of babies at risk of sudden infant death syndrome. Two years later the dominant nonprofit hospital in town offered the same equipment. "Since then they have kept the business for themselves," he says. "We have not had a single baby referred by that hospital." Inman survived by scrambling for customers in nearby cities.

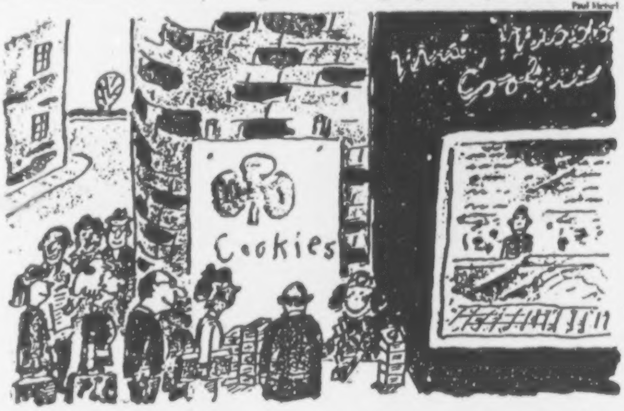
Inman, who has recently testified before the Virginia General Assembly about the situation, is not alone. A diverse army of angry small business owners is mounting a crusade to protest the competition from nonprofit institutions, especially hospitals and universities.

Inman and his compatriots think that, as government funding has waned, nonprofits have used their special tax-free status to muscle into for-profits' turf. Delegates to the 1986 White House Conference on Small Business voted the problem third only to liability insurance and mandated employee benefits in importance.

They have a point. Nonprofits generate $300 billion in annual revenues, and it's not all from the Salvation Army's tin cups. Slick $680-a-year health clubs, magazines chockablock with ads for perfumes, liquor and foreign cars, and church raffles are all counted among the "religious, charitable or educational" activities sanctified by the U.S. tax code.

There's no law that says nonprofits can't make a profit, or an "excess of revenues over expenses," as they euphemize it. Evidence introduced in a Utah court case put the profit margin of the nonprofit Intermountain Hospital chain, the largest nonutility employer in the state, at 10.9% in 1985. But Intermountain was losing an amount equivalent to only 3.3% of revenues on patients who couldn't pay, while for-profit hospitals in the state were losing 4% to 5%.

Paul Meisel



Nonprofits, to be sure, are required to pay regular corporate tax on their "unrelated business income." If the Ford Foundation sells its stock portfolio and buys an auto company, the auto company owes a corporate tax. But what if the Texas University Press publishes T.H. White's *The Book of Merlyn*, a bestseller? Or Harvard University sells a $23,000-a-pop quickie business program for executives? Such activities aren't taxed, since the profits, if any, are intertwined with noncommercial activities of the same institution. In 1986 the Internal Revenue Service collected only $153 million in tax on unrelated businesses of nonprofits. "This is not a big area for compliance," says a spokesman.

Sam Hopmeier sells hearing aids in St. Louis. Since 1980 national use of hearing aids has nearly doubled, yet Hopmeier and other dealers in the area have seen flat volume. During the same period, his records show 13 nonprofit hospitals have entered the St. Louis market. The nonprofit merchandisers benefit from captive referrals within hospitals, as well as a host of property and income tax breaks. "Cost of space means nothing to them," says Hopmeier. "They must be making a ton of money." Not so, says a spokesman for Alexian Brothers Hospital. "We look at this as a natural extension of the hospital's health services, not a profit center. We're not making big bucks."

Bernice Rosmarin, a travel agent in Edison, N.J., has to compete for tour business with such nonprofits as "friends of a museum" or university alumni groups. "They can mail a brochure for 8½ cents that would cost me 39 cents, and we lose commissions on these tours," she says. Harvard and Yale alumni, for example, are cosponsoring a "continuing education" noncredit cruise to France. The Grosse Pointe (Mich.) War Memorial Association is doing a sojourn through the South. "Aren't they supposed to be planting bushes around the war memorial?" asks a spokesman for the

77

Gannett Co., the nationwide news and information company, reported a 12 percent gain in net income for the 13 weeks ended December 28, 1986, the 77th consecutive increase in comparative quarterly earnings since the company went public in 1967.

	Period Ending December 28	
	13 Weeks	52 Weeks
Net Income	+12%	+9%
Earnings Per Share	+12%	+8%
Operating Income	+21%	+18%
Operating Revenues	+26%	+27%

Revenues and income for the fourth quarter and 52 weeks include results of recently acquired operations, including the *Des Moines Register*, the *Detroit News*, *The Courier-Journal* in Louisville, the *Arkansas Gazette* in Little Rock, local newspapers in California, New Jersey, Tennessee and Iowa, W*USA-TV in Washington, D.C., KVUE-TV in Austin, KTKS-FM in Dallas, KHIT-FM in Seattle, and KCMO/KCPW-FM in Kansas City.

Gannett publishes 92 daily newspapers, including USA TODAY, 39 non-daily newspapers and USA WEEKEND, a newspaper magazine. The company owns eight television stations and 18 radio stations. Gannett also owns the largest outdoor advertising company in North America.

For more information about Gannett, write Corporate Communications, P.O. Box 7858, Washington, D.C. 20044.

GANNETT
A WORLD OF DIFFERENT VOICES
WHERE FREEDOM SPEAKS

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American Society of Travel Agents.

In Pullman, Wash., home of Washington State University, computer retailer Gerald Brong is in bankruptcy court. An ill-planned expansion into another town didn't help, he concedes, but his biggest problem was the campus store, which opened a few months after his. "They sell Lotus 1-2-3 for $238, $60 below my manufacturer's wholesale price," he says. Lotus offers academic discounts, and supposedly only students and university staff can get the spreadsheet at the bookstore. But in this college town nearly everyone qualifies or has a friend who does. Some university book and computer stores routinely mail sales brochures to all alumni.

Even when such ventures are set up in taxpaying for-profit subsidiaries, as some now are, critics say the nonprofits have unfair advantages. They include access to cheap venture capital from endowments and the ability to take out up to 10% of pretax profits as charitable contributions.

But what if a university press publishes a bestseller? Or Harvard sells a $23,000-a-pop quickie business program for executives? Such activities aren't taxed.

Politicians have heard the protesters' cries. This month the House Ways & Means Committee will hold the first comprehensive hearings on tax-exempt organizations since 1976, and Treasury is studying the issue.

State and local tax collectors are also taking action. Nashville (Tenn.) Metro Tax Assessor Jim Ed Clary has informed Vanderbilt and other area hospitals that their property tax exemption is under examination and may hinge on the number of charity patients they treat. The Illinois Department of Revenue has sent property tax bills to a posh Rock Island YMCA, as has a county tax assessor in Portland, Ore. The Portland Y is fighting the move on the grounds that physical fitness is in the public interest. If it wins, Frank Eisenzimmer, owner of the nearby Cascade Athletic Club, says he's going to turn his business into a "nonprofit."

"I'm not opposed to the Girl Scouts' having an annual cookie sale," says travel agent Rosmarin. "But if the Girl Scouts want to open a cookie store next door to a Mrs. Fields cookie store, they should have to pay the same taxes."—L.S.

1986

WASHINGTON HOTLINE

Battle hotting up between Michigan firms, nonprofits

By SHARON GELTNER

Representatives of Michigan businesses, ranging from hearing aids salesmen to veterinarians to engineers, are forming a special business coalition in Washington to stop what they term "unfair competition" from nonprofit organizations which offer the same services but aren't burdened by taxes, according to numerous industry and government sources.

This Business Coalition for Fair Competition has already had some success in finding allies in the federal government. The Small Business Administration has issued a report deploring the unfair competition, and has recommended changing the tax code to remove the tax-exempt status from many of the active 780,000 nonprofits around the country.

In addition, the General Accounting Office (the investigative arm of Congress) has begun an investigation into whether the Internal Revenue Service is collecting as much as it should from the "unrelated business income" tax which applies to nonprofits, but is rarely paid.

The major source of revenue for nonprofits today is sales, usually at subnormal rates, and not gifts, grants and contributions. The problem is expected to increase because when the federal budget is being cut, the states will look around for new sources of money, business lobbyists said.

A SBA official put it this way: "We're not talking about going after Goodwill and the Salvation Army. These organizations are very sophisticated with highly compensated executives and they don't pay taxes or contend with the same costs ordinary businesses do."

THINGS CHANGED

Frank Swain, chief counsel of advocacy at the SBA, wrote in his agency's special report that tax-exempt status for nonprofits may have been acceptable when the nonprofit sector was mostly composed of charity organizations. "But it is not adequate today when an increasing number of nonprofits are 'operating' as 'commercial' nonprofits—organizations [which] . . . receive few donations and charge prices for the goods and services they produce."

In Michigan, there have been well-publicized complaints about computer firms competing against state universities.

But there have also been complaints in the traditional merchandise sales, health care and travel industries, as well as the newer laboratory testing, audiovisual services, engineering consulting, data processing, surveying, mapping, computerized design aids production, and soil, forage and water quality analyses.

Not only do businesses in these industries find themselves subsidizing their competitors through paying taxes, but they discover many of these contracts are being awarded by government agencies, such as the Environmental Protection Agency and Defense Department, business lobbyists say.

Bill Swartzendruber of Michigan Testing Engineers Division of Professional Services Industries, said he has been severely underbid or prevented from bidding in competition with the state highway and natural resources departments.

PSI, which has branches in Ann Arbor, Flint, Lansing, Kalamazoo and Detroit, found itself competing for construction quality inspections for counties and municipalities against the state. "Only the state engineering department was approved for the jobs. Everyone else had to go through a six month state pre-approval process, but meanwhile the localities were under deadline to spend their money," Swartzendruber said.

The state legislature finally instructed the highway department to get out of the projects if they were not directly controlled and funded by that department. The rule will become fully effective this year.

BIDDING HAILED

Many businesses, from pharmaceutical firms to sign makers, praise a state law passed just recently, which requires the civil service to put out 75 percent of its jobs for bid to the private sector, among other things, but still believe they have a long way to go to achieve parity. So, they are still looking to the federal government, especially the executive branch, for help. Because of their complaints, the IRS is said to have quietly begun its own in-house task force to investigate exempt organizations, a government official said.

Despite the passage of the state bill, for instance, PSI still faces what it terms unfair competition from the state's natural resources department.

"The federal government gave the department some drill rigs to do soil borings and other tasks. For a while the department used the machines for its own purposes, but then began to work for other state agencies and directly competed with private engineering and testing firms," Swartzendruber said.

Eventually the department considered buying another drill rig to expand the operation but the Lansing-based Consulting Engineers Council raised a ruckus. The rig has not been bought, but the engineers suspect the idea is not yet totally dead.

Roger Haynes, director of government relations for Michigan's National Federation of Independent Businesses, explained the government reasons it needs its own rigs in case of an emergency toxic spill, and a rig needs to be pulled out of one job on the other side of the state and moved elsewhere. However, NFIB, along with the engineering firms, argues the government could contract with a private firm to be on standby.

PRINTING, TOO

The state government also competes directly with private printers, Haynes said, by publishing everything from legislation to stationery and memo pads. The government needs to keep certain sensitive documents secret, but memo pads and other office supplies don't fit that description, Haynes said.

In addition, office furniture companies are sorely hit by Michigan's Prison Industries, the state-run corporation which produces desks, chairs, etc. which are sold to state agencies. PI also provides office equipment to nonprofit organizations at its very low prices, but is not allowed to sell its wares to businesses.

So, said Haynes, Michigan businesses are caught in a double bind. They can't compete with the abnormally low prices, but they are not allowed to buy at those prices either.

However, Haynes and other Michigan business lobbyists assert, the state has begun to move away from its anti-competitive mentality, especially because of the recent law which also requires the Office of Management and Budget to review all state produced goods and services which tend to compete with the private sector. Each department must include in its budget request a cost benefit analysis of the advantages of staying in house or hiring out.

Marty Andrews, a Michigan businesswoman, informally lobbied for Businesses Associated for a Sound Economy, a group of state businesses from various industries banding together to stop competition from schools, Prison Industries and other nonprofits.

ACADEMIC BITE

Andrews, whose firm manufactures signs, ran into competition with Michigan State University, which had a campus student training program, with students producing signs for free, which would have been priced at $250 to $500, Haynes said.

Andrews said before the law was passed the nonprofits had "reduced my sales $100,000 a year." She says she has now seen a dramatic improvement however. "Six months ago I got about one bid a month from government agencies. Now I get three to five a day."

Andrews said she was enraged when the state's Department of Military Affairs called her for information on how much her firm's equipment cost, and for other specifics. She said she complained to Lt. Gov. Martha Griffiths: "It's terrible to take my tax dollars to put me out of business." And the calls from the department stopped.

Andrews recounted that another firm, Abrams Aerial Survey of Lansing, faced a similar problem when it said it could do a job for the state for $17,000.

According to Andrews, the state instead chose to buy its own film and equipment, along with a small airplane and a special air cooled vault, which cost far more than the private firm's charge.

Washington business lobbyists said such practices are part of the "empire building" impulses of officials.

And perhaps the most bizarre nonprofit controversy has surfaced among the state's veterinarians.

Peter Prescott, executive director of Michigan's Veterinarian Medical Association in East Lansing, said his group is facing an uphill struggle against the Humane Society, which opened a $1.1 million facility near Detroit to treat pets.

Prescott and Alan Berger of Utica, claim the society, which does not pay taxes, can afford better equipment and charge far lower prices. The issue is an emotional one, and Berger said his practice was picketed twice by protestors dressed in animal costumes.

"My clients were afraid to cross the picket line," Berger said. He added his practice has fallen from six vets to three and "the end is in sight for us." Prescott said, "Within a 10-mile vicinity of the Humane Society facility, every veterinarian can feel the crunch." ◘

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Michigan Business

EXAMPLES OF ADVERSE EFFECTS OF STATE GOVERNMENT COMPETITION ON THE ECONOMY OF MICHIGAN

1- Quotes for blood test were solicited from a local hospital and the State Department of Health. The quote by the hospital was $20.00 less than the quote by the state. The job was awarded to the state government.

2- A private sign making company quoted $60.00 for artwork for signs at the State Highway Department. The art department within the State Highway Department bid $200.00. The job went to the State Highway Department. Later, a mistake in the artwork was discovered and the State Highway art department billed an additional $200.00, totalling $400.00. If the job had been awarded to the private firm, the bill would have remained at $60.00 even if a mistake had been made.

3- The Michigan State government purchased equipment ranging in cost from $70,000 to $700,000 to do aerial surveying. The expense of the equipment did not include the costs of an airplane and manpower to utilize the equipment. The people who made the decision to buy this equipment ignored the fact that the equipment would be used to duplicate surveying efforts that had already been completed by a private aerial surveying firm which is capable of continuing to give cost effective, high quality surveying to the state, while generating taxes for the treasury, and with equipment that had already been purchased.

4- Despite high unemployment in the private sector of the construction industry, a prison rehabilitation center established a state-supported construction firm in direct competition with building contractors and tradesmen in northern Michigan. The state-supported firm can underbid private contractors because of artificially low, tax-exempt wages for prisoners.

5- Prison industries compete against tax-paying private enterprises for the manufacture of screenprint items, signs, clothing and metal filing cabinets.

6- The Development Center For The Arts of Owosso permits the manufacture of signs for sale to the public without requiring collection of state sales taxes. Further, wages for employees can be paid by government grants in addition to the money received from the sales of the signs.

7- State and county planning commissions are underpricing private consulting firms to provide planning services to cities, villages, townships and counties because the government planning commissions do not pay their own rent, property taxes, state and federal taxes, etc. The "lower prices" of the planning commissions do not factor in all the expenses necessary to provide these services, making it possible to have a lower selling price. Because of this practice, government planning commissions are taking away private business and causing private firms which co be generating taxes to go out of business and their trained personnel to lose their jobs or move out of state to find work.

8- A local temporary employment agency lost its business with the state government because the Department of Management and Budget decided to operate their own Temporary Office Personnel Service for all departments within the state government. "TOPS" has continued to exist despite an appraisal of satisfaction with the service that revealed that various department managers were dissatisfied with the "TOPS" program and preferred the private firm with its lower costs and greater degree of professionalism. The managers cannot use the more efficient and economical, private firms, however, because the Civil Service Commission and the Department of Management And Budget have mandated that all departments use the in-house program.

9- The state government requires that janitorial services in state-owned buildings be performed by civil service employees, who earn a higher rate of pay than unskilled labor in the private sector for the same performance, thus costing more for this service at tax-payers' expense.

10- Likewise for printing services, much of the work is done within government departments with restrictions on the work rules that do not exist in all facets of the private printing market. Where the state contracts printing business to the private sector, it is with the restrictive, arbitrary stipulation about the structure of the work force that is discriminatory against the majority of tax paying workers in printing, with the resulting higher cost of printing being borne by the tax payers of the state.

2

CONTROLLING THE BUREAUCRACY

PRIVATE ENTERPRISE ACT

Every state and region of the country is affected by the growing phenomenon of "government competition." The phrase refers to the practice of a publicly-funded agency producing a good or service in competition with the private sector. Government competition occurs in retailing, printing, manufacturing, education, travel, employment services, communication, wholesaling, warehousing, audio-visual aids, research and development, laboratory testing, day care, and a variety of other areas.

The problem with such competition is that it finds governmental units providing commercial or industrial activity which private sources could provide on a more efficient, cost-effective basis. That point was underscored in a comprehensive study recently concluded (1979) by Professors James Bennett and Manuel Johnson of George Mason University. "Public production of goods is inherently inefficient," concluded the professors, because of government work hours, labor laws, and lack of expertise.

Another study, made public by the U.S. Small Business Administration (SBA) in March 1980, estimated that private sector savings relative to the public sector costs average 35%. The SBA report, drafted after almost 2 years of study, added: "The extent of government commercial/industrial activities is astounding. . .(I)t is the taxpayer who must pay for the government (enterprises) *and* compensate for the tax revenues that are lost when these activities are not performed by the private sector." (emphasis in original)

Thus, government competition acts as an indirect tax upon consumers. Through state and local taxes, wage earners subsidize the paychecks and activity of government workers who do the work that a private source could fund on its own (i.e., with non-public monies). In contrast, contracting-out for commercial/industrial enterprises would broaden the tax base and cut government costs associated with them.

The problem of government competition was first approached in the 1950s. The Small Business Act of 1953 set as national policy the protection of private enterprise, "to maintain and strengthen the overall economy of the Nation." The intent of the SBA Act was reiterated in a 1954 Report of the House Committee on Government Operations, which stated: "Though economy in government operation may be provided in a given case, or the necessity for the government to operate a service may be proved at one time — it is essential to develop competitive industries as soon as possible and the government should step out of the picture."

These general ideas were repeated in an Office of Management and Budget (OMB) circular issued in 1966 and amended in 1972. The OMB directive (Circular A-76) applied only to the federal government, however, and added an important change. It stated that the government should "prefer," rather than rely upon non-government sources for commercial/industrial activity. The Circular excluded from coverage matters related to national security and "products or services available from another government agency."

As of January 1981, no significant action has been taken at state or local levels. The problem remains significant. Of the 48 largest cities in the country, 21 received $29.9 million in revenues (FY 1979) from commercial-type enterprises. When revenues from liquor stores and college dormitories are added to that figure, the number increases to almost $2 billion.

The suggested Private Enterprise Act prohibits government agencies from conducting any commercial/industrial activity, unless expressly authorized by public law. The Act would not ban services that are inherently governmental in nature (e.g., law enforcement and fire protection) since they have a legislative mandate. State operation of liquor stores, utilities and government printing offices would not be a violation of the act since they, too, are authorized by public law.

The Private Enterprise Act exempts state-financed schools from coverage because certain activity is not explicitly authorized by law. These include campus-run facilities like bookstores and cafeterias.

What the act does prevent is the unlegislated commercial/industrial activity by public agencies, which may occur without knowledge or consent of the State Legislature. It also brings state activity into conformity with the stated intent of the Small Business Act.

As a focal point for debate on the Private Enterprise Act, lawmakers may wish to conduct research into the following matters:

(1) The savings that might be realized in specific instances where work is contracted-out by government agencies;
(2) The jobs that are denied to the private sector when work is performed "in-house"; and
(3) The state or local taxes that finance commercial/industrial activity of government agencies.

The Private Enterprise Act is based on a bill introduced before the Arizona House of Representatives in February 1980.

Government Controlling More of the Private Economy
(Billions of Current $)

		(1)	(2) GNP	(3)	(4) Government Control As % of	(5)
Line No.		Total	Private Sector Control	Government Control	Total GNP	Private Sector
(1)	1948	$ 259.1	$ 208.6	$ 50.5	19.5%	24.2%
(2)	1953	366.1	264.5	101.6	27.8	38.4
(3)	1958	448.9	321.3	127.6	28.4	39.7
(4)	1963	594.7	426.9	167.8	28.2	39.3
(5)	1968	868.5	599.6	268.9	31.0	44.8
(6)	1973	1,306.6	901.7	404.9	31.0	44.9
(7)	1978	2,127.6	1,441.6	686.0	32.2	47.6
(8)	1979	2,368.5	1,610.7	757.8	32.0	47.0

Government has increased as a percent of the Private Sector by 94.2% in the 31 years, 1948–1979.

Suggested Legislation

(title, enacting clause, etc.)

Section 1. *[Short title]* This act may be cited as the Private Enterprise Act.

Section 2. *[Statement of purpose]* This legislative body hereby finds and declares that the health, welfare and prosperity of the People of this State are enhanced by the growth of private enterprises. It is the intent of the Legislature to decrease government competition with business by prohibiting state and local agencies from providing certain goods and services.

Section 3. *[Definitions]* For the purpose of this act, the term—

(1) "State agency" means any department, office, commission, institution, board, panel or other creation of the Legislature or Executive branch of state or local government, regardless of whether the Legislature or Executive appropriates public monies to such agency.

(2) "Private enterprise" means any non-governmental entity engaging in the manufacture, processing, offering for sale, rental, leasing, delivery, dispensing, distribution or advertisement of goods and services for profit.

Section 4. *[Restriction on government activity]*

A. A state agency, unless expressly and specifically authorized by statute, shall not engage in the manufacture, processing, offering for sale, sale, rental, leasing, delivery, dispensing, distribution or advertisement, in whole or in part, of any goods or services offered by private enterprise, except as provided in sub-section B of this section.

B. Governing boards of state education institutions may by rule and regulation provide for exemption from the application of this act for activities conducted by institutions within their jurisdiction subject to the following conditions:

(1) Such activities are both a required and reasonably related part of any education educational program which leads to a degree, or

(2) Such activities are offered only to students, employees or guests of the institution and cannot be provided by private enterprise at the same or less cost.

C. In addition, the governing boards of state education institutions may by rule and regulation provide for exemption from the application of this act for the following on-campus activities:

(1) Food service and sales;

(2) Sale of course books and supplies;

(3) Sponsoring or providing facilities for cultural, recreational and athletic events; and

(4) Student housing.

Section 5. *[Severability clause]*

Section 6. *[Repealer clause]*

Section 7. *[Effective date]*

Editorially Speaking

Behind Bars Competition

Balanced budgets, supply side theory, Reaganomics . . . there's a lot of rhetoric flying around these days in connection with our economic woes — nice catch words for easy solutions to unbelievably complex and far-reaching problems. I really don't know who to believe; I suppose you react strongest to those decisions or theories which hit closest to home . . . and there's nothing closer or more real than being laid off or going-out-of-business. That's why I can understand why Marty Andrews, owner and president of Mid Michigan Stamps & Signs Inc., Lansing, is so up in arms.

It seems that in the state of Michigan, as a result of the passing of P.A. 1980 (better known as the Prison Industries Act), the management of correctional industries are now permitted to "operate in a manner as similar as possible to similar private industrial operations, with the goal of achieving a totally self-supported system by October of 1985. To guarantee the industries a share of the market, all agencies, offices and departments of this state shall order goods from correctional industries if the goods are comparable in price and quality to the goods normally purchased by governmental agencies." (I quote from the "Senate Memorandum" of April 7, 1982.)

Now that seems to be a rather harmless piece of legislation, with little or no bearing on the sign industry. Afterall, who could argue with putting our criminal element to work, perhaps paying for some of their upkeep, etc., during incarceration, and maybe even coming out with a marketable skill and renewed sense of worth?

But in fact it does affect Marty Andrews' business as well as a number of other small businesses who rely on government contracts and business from nonprofit institutions such as schools, etc. for a good percentage of their volume. It's not just the problem of government business competing against private enterprise (an ethical consideration in its own right), but that the government competes with unfair advantage without the overhead, tax burden, etc. that private business faces.

As far back as 1908 when the original Correctional Industries Act (P.A. 1908) was passed, the legislature had recognized the potential danger of government competing with private enterprise. However, it was not until the Prison Industries Act of 1935 that a "state use system" was established, whereby it was "unlawful to sell prison products to agencies of other states or to sectarian or private organizations regardless of their charitable or non-profit character." That law further stated that, "in no case shall any prison products be sold or offered for sale at a price below cost of production which cost of production shall include materials, labor, supervision, distribution and selling, heat, light, power and other expenses connected with these." (P.A. 1935, No. 210, Sec. 5)

With the 1980 bill, the essential intent of "state use system" has been eliminated and the potential market for prison goods expanded to include (again, to the Senate Memorandum), "institutions of this or any other state or political subdivision thereof, the federal government or agencies of the federal government or any organization that is a tax exempt under the Internal Revenue Code." Secondly, the pricing structure of prison goods now stands solely with a requirement that "as nearly as practicable, they (the prison industries management) recapture direct and indirect costs exclusive of supervisory costs and indicate fairly the true cost of maintenance and efficiency of management in a system isolated from competitive bidding." (P.A. 1908, No. 15, Sec. 11) By reverting to the wording of the original bill of 1908, there seems obvious intent to favor the looser language.

While the original intent of the law may have been honorable — that is, making a costly state rendered "service" self-supporting — the effect has been disasterous to an already strapped sector of the Michigan economy. The gripes of Andrews and other small business owners can be seen in the bill's far-reaching "snowballing" consequences. Every job given to a prison inmate is one less job given to private enterprise, each additional unemployed individual adds to the burden of the state, each state building is one less source of property tax for the state, each unemployed individual is one less source of income tax and on and on. Or put another way, private citizens are paying for the upkeep of prison inmates who have harmed society in some way but who are now producing goods at often unfair competitive advantage, which in turn is putting the private citizen out of business.

An oversimplification? Sure, but you can understand the concerns of Andrews and others. Examples of such government waste abound, and Andrews has compiled her own special selection under a file that might be headed "government business vs. private enterprise." I can empathize with Andrews and applaud her efforts for bringing such legislation to the attention of not only her own state, but to those outside her immediate area. Sign companies, indeed, small businesses in other states will do well to watch for similar legislation as the individual states try to ride out their own economic problems.

The situation in Michigan has, however, made three things clear to me. 1) You can't always tell the effect of a law by its candy-coated intent; 2) The average citizen will become most concerned when an issue or law hits closest to home; and 3) The economic problems (and solvtions) just are not as simple as they're made out to be. Agreed, nothing too earth shaking; just a little perspective in a difficult time . . . Thanks to Martha Andrews for bringing this to our attention.

Tod Duvernstedt

BUSINESS ASSOCIATED FOR A STRONG ECONOMY
P.O. Box 20171
Lansing, Michigan 48901

TO: Key business owners, professionals and concerned citizens

FROM: Business Associated for a Strong Economy
Marty Andrews, Chairman

RE: Government and non-profit organizations competing with the private sector

Business Associated for a Strong Economy (BASE) was founded in 1982 because businesses were losing income to governmental agencies and non-profit organizations. These groups paid no business taxes and in the case of governmental agencies, their budgets were partially underwritten by taxes paid by the private sector.

BASE views government as a force that can encourage economic growth, but not compete with the free enterprise system by duplicating services or products.

In 1984, with the support of several key legislators, the state house of representatives with a unanimous vote supported House Bill 4634 which became Public Act 15.

The purpose of the law is to draw attention to state agencies duplicating services or products available from private enterprises and have agencies justify their activity or stop unnecessary duplication.

If state government stopped competing with private enterprise, tax revenues and private sector employment would rise. If Michigan voters understood the effects of government competition, including tax-sheltered non-profit corporations and raise the issue with their state legislators, legislation to stop government competition would be introduced.

The attached reprint from the Detroit Free Press details some of the problems still facing business and you as an individual taxpayer. I hope you will take the time to read it. As the article suggests, we may have only touched the "tip" of the iceberg" with P.A. 15.

Examples of direct or indirect government competition abound. Michigan State University allows an optometrist to practice on campus, but does not have a school or Department of Optometry. Their tax-free status allows them to generate profits tax-free. Other "business" areas engaged by universities include printing, a hotel, signage, computer services, medical services, hearing aid clinics and bookstores. Tax-exempt universities may advertise and are doing so at costs below private enterprises.

BASE

Another example is prison industries. The Michigan Department of Corrections generates $13 million and employs 1,000 prisoners at 14 prison factories. Their products and services can be sold to non-profit agencies, hospitals, churches and schools. State agencies are required to buy certain prison products. Prison industries can also sell their products outside Michigan.

While their objectives are laudable, what effect will an expanding prison industries operation have on your business? Should there be restrictions on what can be produced? What impact would 7,000 to

14,000 prisoners producing products have on existing businesses and their ability to expand and create new jobs in the private sector? How can businesses find out what products or services will be produced in the new prisons?

Supporters of free enterprise in Michigan are encouraged to contact their state senator and state representative and ask:

1. What products are going to be produced in the new prisons?
2. How can businesses have input if prison industry products are going to compete with Michigan industries?
3. What are the budgets for building the new prison factories and the administrative costs of the managers operating the new factories?
4. Out of the current prison industries budget, how much income is produced and what are the total costs (including administrative staff)?

At this time, BASE is gathering specific examples and information about government competition which threatens the citizens's and state's economic interests. Please let us know if you are affected. Also, are tax-exempt bodies affecting your ability to do business in significant ways?

Just as critical is our need to educate legislators to the problem of our tax dollars being spent to, quite literally, "put business out of business". If you would like to join our group and be added to the mailing list for the quarterly newsletter, send $10.00 for mailing and postage costs. (Return card enclosed)

Please contact BASE if you want a speaker to address groups to which you belong (517) 374-0860 or 332-2066. You are welcome at our meetings. The meetings are scheduled for the first Friday of the month in Room 471 of the Roosevelt Bldg., 222 N. Seymour in Lansing. Our next meeting is December 6, 1985. There is strength in numbers as we try to share our experiences, pinpoint the problems and then prepare and promote a legislative agenda.

Enclosure

Government competition irks then

George White

Small business operators aren't worried about the international trade deficit or Japanese imports as the automakers are. They believe they have unfair competition much closer to home.

The competitor, which sells clothing and furniture, owns restaurants, movie houses and campsites, is none other than the state of Michigan. And small business owners like Marty Andrews of Lansing say they are committed to getting the state out of private enterprise.

"I'm paying taxes to put myself out of business," said Andrews, president of Mid Michigan Stamps & Signs Inc., and head of Businesses Associated for a Strong Economy, a statewide association of small business owners.

Andrews is not alone in her indignation about the state's commercial activities. Government activity in the private sector has been targeted as one of the top 15 concerns of the Small Business Association of Michigan, a Kalamazoo-based lobbying group.

Officials at Businesses Associated for a Strong Economy and Small Business Association of Michigan say entrepreneurs have complained about the following operations:

- State-o[illegible] campgrounds: Private campground operators say public rec-[illegible]ators have an unfair advantage. State subsidies enable public operators to charge less, and the public facilities also have the benefit of publicly financed signs posted on the highways. Private operators can put up signs, too, but they have to pay for the advertising space.
- Expanded utilities services: Small business owners charge that the utilities have begun [illegible] beyond sales of gas and [illegible] selling heating units and repairs.
- University businesses: Some of the state's universities operate movie houses and restaurants — activities in which they would not be able to engage without state subsidies that also allow them to charge less for their services, the small business groups say.

THESE ACTIVITIES and others were cited by Businesses Associated for a Strong Economy when it lobbied [illegible] bills that would limit state or government-subsidized activity in the private sector. The group scored a point when the state Legislature last year passed a law requiring the state to prepare annual reports outlining the impact of state activity on the private sector.

On Tuesday, Marty Andrews of Businesses Associated will testify before the House Corrections Committee on another issue she said the small business community regards as a serious threat — commercial enterprise by Michigan State Industries, a business run by the State Department of Corrections.

Inmates at five correctional institutions produce shoes, garments, furniture and tool and die equipment that is sold to state agencies and non-profit organizations. Sales last year totaled $10.7 million on operating expenser of about $9.4 million.

Andrews said she is not opposed to job training for inmates, but she objects to the manufacture of products for sale by Michigan State Industries, which takes important business from some private enterprises, she said. As a result, many businesses cannot afford to expand their work force, she contended.

"These kinds of activities force us to lay off workers," she said. "MSI said they are providing job skills, but we can't afford to hire the inmates when they're released."

THE PRISONERS' impact on the private sector is not significant, according to Howard Gentry, deputy director of Michigan State Industries. "We're teaching prisoners the work ethic and giving them a trade that will enable them to stay out of prison when they're released," said Gentry.

Gentry said Michigan State Industries [illegible] the [illegible] private sector because most of the raw materials used in prison production come from Michigan businesses. For example, the program bought about $5 million in materials last year, Gentry said, and employs 108 civilians, he said.

Some state legislators say they can't assess the impact of Michigan State Industries' operations because the state is just beginning to evaluate state-related commercial activity. State Rep. Debbie Stabenow, a Lansing Democrat who co-sponsored a bill that established the commercial impact statement process, said she supports the program's operations. However, the issues raised by Businesses Associated for a Strong Economy are important, and the state should assess the impact of any agency's commercial expansion plans, she said.

Officials at Businesses Associated for a Stron Economy and Small Business Association of Michigan say entrepreneurs have complained about state-owned campgrounds, expanded utilities services and university businesses.

See attached:

Ingham County
Social Service

Read the attached complaint to vendor sheets to see where $300,000 of your tax money was spent and the prison industries have refused to replace any of the merchandise.

File cabinets are spliting at the seams after one year of use. Springs are coming through the chair seats, etc. File cabinet drawers will not close completely.

Do we want salesmen on the road from prisons selling to business and non profit organizations?
Do we need 20 more manufacturing plants in prison industries competing with business and laying off private citizens?

Plans are to allow prisons to buy from prisons out of state and resell within other states.

Think of the impact this could have on our state and the employment of the private sector in Michigan. This would create less taxes flowing to government and more wages coming from taxes for state employees.

Corrected copy

STATE OF MICHIGAN
COMPLAINT TO VENDOR

VENDOR: CONTACT THE AGENCY PROMPTLY TO RESOLVE THIS COMPLAINT. THIS FORM BECOMES A PERMANENT PART OF YOUR RECORD WITH THE PURCHASING DIVISION. UNANSWERED OR REPEATED COMPLAINTS TO VENDORS MAY RESULT IN YOUR REMOVAL FROM THE STATE'S APPROVED VENDOR LIST.

COMPLAINT NUMBER ☐ 1 ☐ 2 ☐ 3

DATE OF COMPLAINT 7/19/85	PURCHASING DIVISION BUYER OR UNIT NO. Bureau of Facilities DMB	
CONTRACT NUMBER N/A	ORDER NUMBER F85-F11011 0696	ORDER DATE 10/12/84
NAME OF COMMODITY OR SERVICE Tables		

VENDOR ADDRESS
TO:
Michigan State Industries
Logan Center
Lansing, Michigan 48913

AGENCY ADDRESS
FROM:
Ingham County DSS
5303 S. Cedar
Lansing, MI 48910

NATURE OF COMPLAINT

Check one or more below.

☐	SHIPMENT OVERDUE	☒	ITEMS DO NOT MEET SPECIFICATIONS	☐	OVERSHIPMENT
☐	RECEIVED IN DAMAGED CONDITION	☐	UNAUTHORIZED SUBSTITUTE	☐	UNDERSHIPMENT
☐	UNAUTHORIZED DELIVERY	☐	UNSATISFACTORY WORK IN INSTALLATION	☐	NO INVOICE RECEIVED
☐	AMOUNT RECEIVED VARIES FROM PACKING SLIP	☐	COMMODITY LACKS REQUIRED INSPECTION STAMPS OR DOCUMENTS	☐	SERVICES NOT PERFORMED ACCORDING TO SPECIFICATIONS

Agency give detailed explanation of complaint in this space, using additional sheets if necessary.

Tables

All tables delivered by MSI in 12/84 and 1/85 contained an oily substance that rubbed off on employees and their clothing. Additionally, the oily substance damaged two Westinghouse acoustical panels in one office.

We are seeking replacement of the panels and installation costs.

Panel	$176.21
Panel	89.78
Total	$265.91

The table tops were cleaned by MSI personnel.

SIGNATURE

TITLE

WHITE - VENDOR
GREEN - PURCHASING DIVISION
GOLDENROD - PURCHASING DIVISION
BLUE - AGENCY
PINK - AGENCY

This letter was mailed to college
presidents and the Board of Trustees
of Michigan State University.

November 21, 1985

I am writing you as . . .

. . chairperson of Business Associated for a Strong Economy (BASE), which is an association of business interests united by a strong concern regarding government and non-profit competition with the private sector.

BASE was founded in 1982 because businesses were, and are, losing income to some governmental agencies and nonprofit organizations. These groups pay no taxes and in the case of government agencies, their budgets partially underwritten by taxes drawn from the private sector.

We are specifically concerned about situations that have been brought to our attention regarding possible competition between small business and our universities. As public policies change and universities change to meet public needs and demands, we are concerned that our policy makers evaluate the full impact of decisions to allow university departments to contact with private individuals for goods and services or decisions to provide needed services "in house" instead of contracting with the private sector.

To that end, we are interested in communicating with you or your staff as situations arise that are received as potentially unfair competition with Michigan businesses. We believe this is best done as specific decisions are being made and that it would be most helpful if (university name) had an office and/or person designated as the Business Ombudsman for the University. This office could be advertised as the place to call if businesses have questions or concerns and we could communicate directly with this office as situations are brought to our attention.

BASE sincerely believes that communication is the key to resolving any unfair competition -- whether real or perceived. We realize we have a high quality university system in our State and we are interested in maintaining and improving our economic base so that our public services can be adequately funded. To achieve this, we believe the private sector must be allowed to grow without unfair competition from the public sector.

We would greatly appreciate your response to our request and we look forward to a postive working relationship.

Sincerely,

Marty Andrews
Chairperson
Business Associated for a Strong Economy

STATE OF MICHIGAN

COMPLAINT TO VENDOR

Corrected Copy

VENDOR: CONTACT THE AGENCY PROMPTLY TO RESOLVE THIS COMPLAINT. THIS FORM BECOMES A PERMANENT PART OF YOUR RECORD WITH THE PURCHASING DIVISION. UNANSWERED OR REPEATED COMPLAINTS TO VENDORS MAY RESULT IN YOUR REMOVAL FROM THE STATE'S APPROVED VENDOR LIST.	DATE OF COMPLAINT 7/19/85	PURCHASING DIVISION BUYER Bureau of Facilities DMB	
	CONTRACT NUMBER N/A	ORDER NUMBER 85-[illegible]1206 0746	ORDER DATE 10/12/84
COMPLAINT NUMBER 1 2 3	COMMODITY OR SERVICES COVERED BY COMPLAINT Lateral Files		

VENDOR ADDRESS

TO:

Michigan State Industries
Logan Center
Lansing, Michigan 48913

AGENCY ADDRESS

FROM:

Ingham County DSS
5303 S. Cedar
Lansing, MI 48910

NATURE OF COMPLAINT

Check one or more below.

	SHIPMENT OVERDUE	X	ITEMS DO NOT MEET SPECIFICATIONS		OVERSHIPMENT
	RECEIVED IN DAMAGED CONDITION		UNAUTHORIZED SUBSTITUTE		UNDERSHIPMENT
	UNAUTHORIZED DELIVERY		UNSATISFACTORY WORK IN INSTALLATION		NO RESPONSE TO PRIOR COMPLAINT
	AMOUNT RECEIVED VARIES FROM PACKING SLIP		COMMODITY LACKS REQUIRED INSPECTION STAMPS OR DOCUMENTS		SERVICES NOT PERFORMED ACCORDING TO SPECIFICATIONS

Agency give detailed explanation of complaint in this space, using additional sheets if necessary.

Received	154	5 drawer lateral files with door without locks at	$402.85	$62,038.90
	62	5 drawer lateral files with doors, with locks at	$419.60	$26,015.20
				$88,054.10
	15	lateral files at	$350.30	$ 5,254.50
	231	lateral files		$93,308.60

Put all files into use on 1/2/85. Of the 231 files received, approximately 10% are in working order.

Specifically

1) drawers and doors do not close properly
2) sliders are faulty
3) doors jump off tracks
4) doors are bent
5) paint finish damaged due to poor fitting

We request total replacement of all 5 drawer lateral files due to the poor quality of the files provided by the vendor.

If the vendor can not replace with a substantially better quality file, ie. heavier gage steel, better quality sliders, etc, we request total reimbursement and permission to purchase from a qualified vendor.

SIGNATURE

TITLE

WHITE - VENDOR
GREEN - PURCHASING DIVISION
GOLDENROD - PURCHASING DIVISION
BLUE - AGENCY
PINK - AGENCY

FORM DMB 218 REV. 2-78

STATE OF MICHIGAN
COMPLAINT TO VENDOR

control copy

VENDOR: CONTACT THE AGENCY PROMPTLY TO RESOLVE THIS COMPLAINT. THIS FORM BECOMES A PERMANENT PART OF YOUR RECORD WITH THE PURCHASING DIVISION. UNANSWERED REPEATED COMPLAINTS TO VENDORS MAY RESULT IN YOUR REMOVAL FROM THE STATE'S APPROVED VENDOR LIST.

COMPLAINT NUMBER ☐ 1 ☐ 2 ☐ 3

DATE OF COMPLAINT: 7/19/85

PURCHASING DIVISION BUYER: Bureau of Facilities DMB

CONTRACT NUMBER: N/A

ORDER NUMBER: P 11042 4369

ORDER DATE: 5/18/84

COMMODITY OR SERVICES COVERED BY COMPLAINT: Chairs

VENDOR ADDRESS

TO:

Michigan State Industries
Logan Center
Lansing, Michigan 48913

AGENCY ADDRESS

FROM:

Ingham County DSS
5303 S. Cedar
Lansing, MI 48910

NATURE OF COMPLAINT

Check one or more below.

☐	SHIPMENT OVERDUE	☒	ITEMS DO NOT MEET SPECIFICATIONS	☐	OVERSHIPMENT
☐	RECEIVED IN DAMAGED CONDITION	☐	UNAUTHORIZED SUBSTITUTE	☐	UNDERSHIPMENT
☐	UNAUTHORIZED DELIVERY	☐	UNSATISFACTORY WORK IN INSTALLATION	☐	NO RESPONSE TO PRIOR COMPLAINT
☐	AMOUNT RECEIVED VARIES FROM PACKING SLIP	☐	COMMODITY LACKS REQUIRED INSPECTION STAMPS OR DOCUMENTS	☐	SERVICES NOT PERFORMED ACCORDING TO SPECIFICATIONS

Agency give detailed explanation of complaint in this space, using additional sheets if necessary.

Received	198	executive chairs at	$156.60	$ 31,600.80
	86	posture chairs with arms at	$150.40	$ 12,934.40
	16	posture chairs without arms at	$120.10	$ 1,921.60
	51	sled chairs at	$123.90	$ 6,318.90
	13	executive high back chairs at	$204.75	$ 2,661.75
	64	stateman chairs with arms		$ 5,919.40
	4	posture stools at	$158.35	$ 633.40
				$ 61,990.25
$19 surcharge for use of Westinghouse material				$ 8,208.00
				$ 70,198.25

We received the above noted equipment in December, 1984 and put it into use on 1/2/85.

All of the upholstered furniture received from MSI is becoming unusable due to chair frame and cushion failures.

Specifically

1) All cushions are flattening after 7 months of use causing the fabric weave to separate.
2) Steno chairs - i.e. posture chairs will not hold adjustment.
3) Some chairs are wobbling.

All chairs noted above should be replaced due to poor quality of those provided by the vendor.

If the vendor can not replace with a better quality cushion, including all new fabric, and fitting for steno chairs, we request total reimbursement and permission to purchase from a qualified vendor.

SIGNATURE

TITLE

WHITE - VENDOR
GREEN - PURCHASING DIVISION
GOLDENROD - PURCHASING DIVISION
BLUE - AGENCY
PINK - AGENCY

Non-profit competition in general is effecting the business climate in Michigan. We are losing business to other states. Taxes cannot be reduced until we have a proper balance between state government and business.

The memo dated April 12, 1971 in your previous folder has been used by purchasing agents as a mandate. Can you send a retraction or a notification to Management and Budget to not recommend purchasing from state prisons. Send a memo to State Agencies that have the right to purchase from outside supplier whenever they feel it is in the best interest of the agency and public to do so.

After the mandate was sent by Department of Administration which decreased business to sign companies I was forced to lay off four employees, one a paroiee, who came back one year later begging for his job back.

In recent meetings with Howard Gentry, Department of Corrections, he state that their sign shop went $40,000.00 in the red last year.

I understand there are to be twenty new manufacturing plants in the new prisons. This would increase lay offs in private sector and a loss of taxes to government. This will put more people on welfare and unemployment.

Prisoners need to be trained for jobs in the private sector. Their training does not have to mean the production of products in such a volume that jobs are lost in the private sector.

Ingham County Social Services came to BASE hoping we could assist in getting information to the right people to assist them with their problem.

In January of 1985 $300,000.00 worth of file cabinets and chairs were made and they fell apart by June of 1985.

You are collecting documented facts that the State employees and State Police officers have worn shoes that are uncomfortable until this year, because of nails in the shoes. Until after Public Act 15, changed to Public Act 431 of 1984 which you should review closely as they could have an impact on these issues.

For instance, train on shoe manufacturing by allowing prisoners to use these items and supply to agencies with shoes for those who cannot afford shoes. This should help them accomplish a goal without competing, or, allow them to make their own shoes.

Senator Welborns' office stated the use of equipment, milles and grinders from manufacturing shops have been made into knives by prisoners and used for violence. Plexiglas knives made from sign materials could be dangerous.

More examples next week: Department of Natural Resources, Recreation and Michigan Well Drillers.

The Federal level is promoting a bill to allow prisons to buy from one another and resell. The Federal level is also promoting a bill to mandate that all non-profits buy from prisons only. Please recommend a committee look into this bill to see if it is as anti-business as it appears.

Now if the Universities and prisons sell to the private sector and non-profit organizations beings schools, cities, counties, churches, townships and government who is left to buy signs and printing merchandise from businesses? Some businesses very seldom buy a large volume of signs, bedding, etc. as these items last for a long time.

There is also a bill that will allow farm land to be purchased by Department of Corrections to allow prisons to compete with farmers.

Steve Wagner and myself met with Glen Stevens from the University President Council encouraging an Ombudsman between Business and Higher Education. Appoint a person from each University to review complaints on University competition.

A Michigan State University employee called my business for two months getting information and prices on signs. Then they sent a person in to get a quote on my lowest possible prince on 600 nametags. They then quoted that price to Department of Labor who gave the contract to Michigan State University. After Michigan State University was awarded the contract they called to borrow my brass dies and instructions on manufacturing the product.

Michigan State University Health Clinic is advertising on the radio using tax dollars to promote business. However, the Veterinary Clinic does not advertise on the radio. Should Michigan State University be allowed to advertise medical services and be in competition with new medical graduates who are trying to start their practice?

Universities are competing with: travel agencies, recreational facilities, well drillers, optometrists, hearing aid sales, railroad contracts on design, theaters, rental of building for weddings, etc.

Universities are also sending professional sales staffs on the road to compete with business.

Your committee can help present businesses to rebuild Michigans' economy if Management and Budget and legislators are made aware that privitization of services will increase employment within Michigan and reduce government costs.

To help subsidize new business start ups without consideration for assisting the present businesses will only hurt old businesses. It is a well known fact that 80% of new businesses fail. To put them in competition with the already floundering businesses is the same as prison and government competition.

As a committee we have been discussing the proposed Business Umbrella Plan to help businesses start up. As an owner of a small business I question the State of Michigan giving assistance to a new company being my competition.

I would prefer a program to help all present small businesses equally.

One approach the state could take is to have retired business executives work on sight in the businesses that are seeking assistance for a period up to one month. In this way they would be abel to work with the owner and institute plans, find out if the plans will be sucessful and if not make the appropriate changes.

In the past state government and Chambers have established hot lines where business owners could get help. In my opinion, this has been of limited value because the consultant has not been able to provide a realistic evaluation of the problem.

This service should be a pay back grant with a minimum service charge to all businesses working in this system.

One advantage of having the consultant work in the business is that they could evaluate the level of competiton from Prison Industries and recommend changes to the Department of Commerce and the Governor.

An important market for many small businesses is the cities, school districts, universities, churches, hospitals and state agencies. Without free competition for these customers the small businesses will have an insufficient base on which to grow. Presently prison industries is advertising in the Michigan Township magazine and in architectural magazines.

RECOMMENDATION TO STOP CRIME IN ORDER TO REDUCE MICHIGAN INDUSTRY'S NEED FOR MORE PRISONS:

1. Set up inexpensive training programs to train prisoners for all professions. When prisoners are released, they will be able to apply for various professions and find employment;
   - A. Rotate prisoners on training program.
   - B. Ask for donations from citizens & businesses of used typewriters, vehicles, irons, toasters, computers, etc. to train prisoners for up-to-date employment needs (the need for assembly line workers is decreasing rapidly).
   - C. Provide funds to local system when criminal is caught and is a first time offender. If rehabilitation takes place on the local level, there would be no need for imprisonment except for habitual offenders, if the program works. Unused schools can be purchased for $2.00 in local areas to set this program up, guided by trained staff and police.
   - D. Set up programs for On-The-Job Training with private businesses.

2. Investigate Michigan Industries to see if it is cost effective or if tax payers are subsidizing material costs and overhead expenses (buildings, equipment, wages, etc.) Public Act 15, signed Feb. 29, 1984 (HB 4634).

3. Keep big business from being subsidized by low costs of manufacturing by Michigan Industries (which is funded by tax dollars from businesses and citizens), and reverse the trend of small businesses being put out of business by competition from Michigan Industries.

4. Allow prisons only for training and housing of prisoners.

5. Sales from prison manufacturing are keeping men from working in the private sector:
   - A. Citizens working in private sector jobs outside of prison earn larger wages which are taxable, increasing the tax flow to government.
   - B. Keep crime down because of more jobs available.
   - C. Keep supply and demand revolving from purchases which create more jobs. (prisoners do not buy cars, food, clothing, furniture, etc.)
   - D. It is unfair competition when state government has local municipalities, state departments and school districts buy items from prison industries and not from private sector manufacturers.

When the Federal government added the 5% increase to the gasoline tax to repair roads, they specified in the amendment to the bill that all road signage was to be manufactured by the private sector. This laid off 4,000 prisoners at the Federal level who were manufacturing road signage, creating jobs in the private sector. When things like this occur, this takes people off welfare lines.

Small business has suffered enough from layoffs forced by government competition, university competition, prison industry competition, high taxes on unemployment, etc. Please; we cannot subsidize prisons whose manufacturing will compete against our firms in the future. As knowledgeable men and women, find out the true facts before making decisions that will effect both prisons and the private sector for years to come.

THE SENATE
LANSING, MICHIGAN

SENATE REPUBLICAN OFFICE
BILLIE S. FARNUM BUILDING
ROOM 1040
LANSING, MICHIGAN 48909

(517) 373 7[illegible]
(517) 373 [illegible]

M E M O R A N D U M

TO: Paula Johnson

FROM: Renze Hoeksema RH

RE: Prison Industries -- Legislative History

DATE: April 7, 1982

Michigan's prison industries' system was established under P.A. 210 of 1935. In nearly fifty years the structure of the system has remained rather stable; however, the purpose and intent of the prison industries' system has undergone major revisions--the most revolutionary being proposed and adopted in 1980.

These legislative revisions may generally be localized to two Acts, P.A. 15 of 1968, establishing the Correctional Industries Act, and P.A. 245 of 1980, which amended that Act. This overview will concentrate on the three acts already mentioned--focusing on the statutory changes which have altered the purpose and intent of prison industries, insuring them a competitive advantage over the entities in the private sector.

From their inception, prison industries have been intended to provide for the employment of inmate labor in the correctional institutions of this state. However, in recent years this purpose has become secondary to the overriding concern that prison industries be changed from a system which requires intermediating financial assistance to a total self-supporting system.

In 1935, under the Prison Industries Act, the Legislature provided for its first purpose (inmate employment), by establishing a "state use system" of the prison industries. It was unlawful to sell prison products to agencies of other states or to sectarian or private organizations regardless of their charitable or nonprofit character. The Act also stated, "that in no case shall any prison products be sold or offered for sale at a price below cost of production which cost of production shall include materials, labor, supervision, distribution and selling, heat, light, power and all other expenses connected these with." (P.A. 1935, No. 210, Sec 5) The Legislature clearly intended that the market for prison products be limited to state institutions, and that they were priced with some semblance of cost.

By the summer of 1968, the Legislature had repealed the Prison Industries Act, and replaced it with the Correctional Industries Act. This Act, as its title denotes, reflected a change in the Legislature's attitude regarding prisons, as well as the prison industries' system. The legislative intent of a "state use system" was deleted, and the pricing structure of prison products stood solely on the loose requirement that as nearly as practicable they recapture direct and indirect costs exclusive of supervisory costs and indicate fairly the true cost of maintenance and efficiency of management in a system isolated from competitive bidding. (P.A. 1968, No. 15, Sec. 11(a)(ii))

The evolution toward a totally self-supported prison industries' system was culminated in 1980 with the revision of the Correctional Industries Act. Prison industries may now sell their products to institutions of this or any other state or political subdivision thereof, the federal government or agencies of the federal government or any organization that is a tax exempt organization under section 501(c)(3) of the Internal Revenue Code. (P.A. 1980, No. 245, Sec. 6)

It is now the expressed intent of the Act to permit the management of correctional industries to operate in a manner as similar as possible to similar private industrial operations, with the goal of achieving a totally self-supported system by October of 1985. (P.A. 1980, No. 245, Sec. 11(d)(2)) To guarantee the industries a share of the market, all agencies, offices, and departments of this state shall order goods from correctional industries if the goods are comparable in price and quality to the goods normally purchased by governmental agencies. Prices are to be fixed to recapture all direct and indirect costs. (P.A. 1980, No. 245, Sec. 11(3)(ii)(iii))

While it is undisputed that the legislative intent from the beginning has been to guarantee prison industries a share of state purchases in order to provide for the employment of inmate labor, the system today functions less as a rehabilitative program but more as a government owned and promoted industry. Clearly, if the prison industries are to be self-sufficient by 1985, they will have to aggressively pursue a larger market share. Today, the industries finance 40 percent of their operations. Their financial growth is dictated by 20 percent annual appropriation reductions through 1986.

One other change worth noting is the use of the prison industries' revolving fund. All money collected from the sale or dispositon of goods, wares, and merchadise manufactured by inmate labor, or received for services provided by labor in the correctional institutions, shall be turned over to the State Treasurer and credited to the correctional industries' revolving fund. Through 1980, this fund was used to pay for contractual services, supplies, materials and equipment representing the direct and indirect costs of the industries, and to pay inmate wages. Surpluses in the fund at the end of each fiscal year were transferred to the General Fund. (P.A. 1935, No. 210, Sec. 2; P.A. 1968, No. 15, Sec. 5)

Today, the correctional industries revolving fund operates as a reserve fund. The fund still pays for the "cost of doing business;" however, surpluses are not automatically transferred to the General Fund but remain in the fund to finance future commitments of the industries. (P.A. 1980, No. 245, Sec. 5)

Secs. 16, 17, P.A.1935, No. 210

These sections, a repealer and a severability clause, were repealed by P.A. 1945, No. 267, Imd. Eff. May 25. Section 16 repealed the following:

P.A.1909, No. 140 (C.L.1929, §§ 17608–17613).
P.A.1911, No. 150 (C.L.1929, §§ 17614–17623).
P.A.1911, No. 151 (C.L.1929, §§ 17624–17631).
P.A.1917, No. 202 (C.L.1929, §§ 17632–17636).
P.A.1921, No. 343 (C.L.1929, § 17644).
P.A.1907, No. 291 (C.L.1929, § 17645).

800.318 Provisions in conflict with national prison labor authority void

Sec. 18. Any provision contained in this act which is in conflict with the rules and regulations of the national prison labor authority is hereby declared void.

Historical Note

Source:

P.A.1935, No. 210, § 18, Eff. Sept. 21.

800.319 Requisition, production and distribution of prison products for state use; state administrative board, duties

Sec. 19. Requisition, production and distribution of prison products for state use. It shall be the duty of the state administrative board to prepare annually in advance an itemized estimate of the articles and materials required for proper use by the institutions, departments and offices of the state which may be produced by prison industry; and the state administrative board shall have the authority to require of each of said institutions, departments and offices such reports as may be necessary for the purposes of such estimate. It shall be the duty of the state administrative board to issue purchase orders to the prison commission for all of said estimated articles and materials insofar as the prison commission shall deem it practicable to produce same with prison labor; and it shall be the duty of the prison commission to fulfill such purchase orders as requisitioned in strict conformity with the specifications upon which they are based. After consultation with the prison commission and the officials in control of said institutions, departments or offices of the state, the state purchasing agency shall prescribe the specifications for prison products, and shall have authority to inspect, accept or reject said prison products to the same extent as if the same were purchased from other sources.

Historical Note

Source:

P.A.1935, No. 210, § 19, Eff. Sept. 21.

Library References

Convicts ⚷13. C.J.S. Convicts § 26.

PRISON REIMBURSEMENT ACT

Library References

M.L.P. Convicts and Prisons § 1.

P.A.1935, No. 253, Imd. Eff. June 8

AN ACT relative to the state penal institutions, and the care and maintenance of prisoners therein; and to provide for the reimbursement of the state on account thereof in certain cases.

The People of the State of Michigan enact:

800.401 Short title

Sec. 1. This act may be known and cited as "The Prison Reimbursement Act."

Historical Note

Source:

P.A.1935, No. 253, § 1, Imd. Eff. June 8.

Notes of Decisions

1. Construction and application

The prison reimbursement act imposes a civil liability on all prisoners able to pay for their maintenance, whether they were sentenced before or after the effective date of the act, but such liability does not extend to any period of imprisonment prior to the effective date of the act. Auditor General v. Olezniczak (1942) 4 N.W.2d 679, 302 Mich. 336.

A prisoner's statutory obligation under the prison reimbursement act to pay for his maintenance, if he has a sufficient estate, is "civil" rather than "criminal" in character. Id.

800.402 Reports of prisoner's financial responsibility to auditor general; forms

Sec. 2. The warden of the state prison at Jackson, the branch of the state prison at Marquette, and the house of correction and reformatory at Ionia, shall forward to the auditor general a list containing the name of each prisoner, the county from which he was sentenced, term of sentence, date of admission, together with all information available on the financial responsibility of said prisoner. Such report shall be made on blanks to be furnished by the auditor general, and shall be made on or before the tenth day of each month.

Historical Note

Source:

P.A.1935, No. 253, § 2, Imd. Eff. June 8.

Library References

Prisons ⚷9.

C.J.S. Prisons § 11.

LANSING STATE JOURNAL Sun., Oct. 24, 1982

Prison industry is big business

By TARA CONNELL
Gannett News Service

Call the toll-free reservations number of Best Western hotels and a female inmate of an Arizona prison probably will answer.

An inmate who once dished out meals in Minnesota now may be making computer-disc storage drives. And the prisoner who used to punch out license plates now could be making printed circuits for the Defense Department.

TODAY, MORE THAN 40,000 of the 384,000 men and women in 43 federal and 500 state prisons are making electronic equipment, computer components, eyeglass lenses, furniture and adobe bricks. Sales of inmate-produced goods are expected to exceed $400 million this year, up 14 percent.

Goods produced by federal prisoners alone are expected to sell for $145 million and bring the federal Prison Industries Inc. a record $22 million profit. Most profits from federal and state programs go back into prison industries.

Big business has come to the nation's prison system. And it's getting bigger.

ALABAMA, FOR instance, is attacking two problems — prison overcrowding and idleness — with one plan. It is building two new prisons containing factories.

Alaska, the only state without an income-producing industry in its prison system, in September appointed a program director and a commission to create one.

Since 1975, two federal projects have encouraged 11 states to try new types of industrial programs. The most successful — in Arizona, Minnesota and Kansas — have joined private firms to reduce prison costs and, in Arizona, make a $100,000 profit.

But, in these days of recession and high unemployment, the programs are not without controversy.

THE NUMBER OF inmates is growing — by 10 percent this past year — at a time when society seems to be turning away from the philosophy that prisons should rehabilitate. So, as prison industries are needed to replace abandoned rehabilitation programs and help pay for housing inmates, the economy is burdening the existing system with more bodies, less money, fewer buyers and a dispute over whether convicts should be working when civilians aren't.

Prisoner-interest groups fear a throwback to the age of slave labor, when gangs of inmates were trucked to a private farm, worked until they dropped and returned to a dingy prison.

"THERE IS the danger that this will give governments the opportunity for control of the labor force, where the duration of a prisoner's stay is not based on the (crime committed) but on the need to maintain a labor force," says David Rothberg of the Fortune Society, a group founded by ex-convicts and advocating prisoner rights.

See SOME, Page 11D

Some prison industries forced to lay off inmates

Concluded from Page 7D

Organized labor is concerned that prisoners will take jobs from civilians.

"Labor has historically supported the idea of prison industry, but if it's depriving the populace, then it's another ballgame," says the AFL-CIO's John Zalusky.

AS PRISON industries become more like businesses, they also become more vulnerable to vagaries of the economy. Utah has even laid off inmate workers: As declining car sales cut the need for license plates, the work force making the plates has dropped from 56 to 15.

Minnesota had hoped to employ 120 inmates in its joint program with Control Data Corp. to make computer-disc storage drives. Only 50 are working because of low demand.

"The name of the game now is survival," says Patrick D. McManus, Kansas' corrections director.

THROUGHOUT ITS two-century history, prison industry has been sensitive to economic and social trends. During the early 1800s, a warden was judged on his ability to run a facility at no cost to the taxpayer. The result was excess. "It was typical to sell prisoners to private industry, where they were worked to death," says Barbara Auerbach of the American Institute of Criminal Justice Studies.

Eventually, prison industries became so successful they began competing with private business, and laws were passed to prevent unfair competition.

Now, most states restrict the sale of goods made in prisons to tax-supported institutions.

IN THE PAST five years, a handful of states have changed their laws to allow sales to private industry. In 1979, the federal Hawes-Cooper Act was changed to allow interstate transportation of prison-made goods for seven model programs.

There is legislation pending to drop restrictions on the sale of inmate-made products [illegible] compete on the [illegible].

In traditional programs, inmates are paid from $1 an hour to [illegible] a day. In states where prisoner-made goods can be sold to private firms, inmates have to be paid the prevailing wage for the industry, to relieve questions of unfair competition. Then, [illegible] percent of the wages can be taken in federal and state taxes, room and board at the prison and family support.

"In my experience, there are basically only two kinds of incentives for inmates," says Jimmy [illegible], a former inmate just three months out of California's San Quentin after a four-year term for armed robbery. "One is money. The other is time off."

Prison trade boom helps inmates

By **MALCOLM JOHNSON**
Associated Press Writer

If state officials want to study a successful business in economically depressed Michigan, they only need to look behind their own prison walls.

The state's prison industries have been doing a booming trade in furniture, bedding, clothing and license plates, and some inmates have been pocketing record income, corrections officials say.

The behind-bars enterprise had its best quarter ever in July-September, the last quarter of the state's fiscal year, with one inmate earning a record $1,300 as a bonus for the three months, state officials say.

OFFICIALS ARE quick to assure, however, that the big jump was a fluke – stemming from a combination of price increases and a late shipment — and that inmates are not getting rich while many Michigan workers are unemployed.

They defend the bonus payment program as a valuable incentive for inmates at prisons in Jackson, Ionia and Marquette to behave themselves in prison and save a nest egg for future freedom.

"Prison industries has become a good place to work for the inmates," said Frank Beetham, deputy Corrections Department director in charge of prison shops.

Beethem said the record bonus for the quarter went to a veteran Marquette Prison inmate who made clothing. About a dozen others earned more than $1,000 apiece, while the average bonus was about $350 for the quarter and $439 for the year.

ONE INMATE at Ionia has built up about $14,000 in savings over about 20 years, he said.

Of about 950 inmates working in prison industries, roughly 600 qualify for the bonus program.

But Beetham adds, "We'll never see another bonus this high again."

He said the big jump in sales and bonuses stemmed mainly from two factors.

A new state law requires prison industries to become self-supporting by 1986, and Beetham said that requires the agency to raise prices it charges other state departments and non-profit organizations that use prison-made goods.

"We've never sold our products where we should sell them" as far as cost goes, Beetham said. "We've always sold at cost. Now we can price our products to the market."

ANOTHER FACTOR that ballooned final quarter earnings was the delayed opening of the Huron Valley Men's Facility, he said.

A large order of furnishings was made earlier in the year but was held in the warehouse until the final quarter, and items are not paid for until they are delivered.

So sales for the July-September quarter soared to nearly $2 million, he said, and prisoners' bonus pay rose.

"The amount of the bonus is determined by the prisoner's pay scale, the number of hours he worked and his gross earnings," Beethan said. "The more skilled they are and the harder they work, the more money they make.

"The bonus is designed to compensate the more skilled worker, the conscientious worker, the quality worker."

THE PROGRAM cuts down on turnover and internal problems, he said, and "stabilizes the workforce."

Patrick Murphy, a spokesman for Attorney General Frank Kelley, who has gone to court many times seeking reimbursement from inmates for their room and board, said the bonus money is exempt from such seizure.

"We don't want to take all the incentives out," Murphy said.

Gas tax bill could hurt prison industry

By NANCY BENAC
Associated Press Writer

State corrections officials are mapping strategy to fight a new federal law they claim is on a collision course with a Michigan prison industry where inmates make highway signs.

State Corrections Director Perry Johnson said that a ban on prison-made materials for federally financed transportation projects was quietly added to the 5-cent-a-gallon federal gasoline tax increase approved by Congress in December.

Johnson said he learned of the provision Monday and would send Gov. James Blanchard a letter asking for help in getting the law changed.

FRANK BEETHAM, a deputy corrections director in charge of Michigan prison industries, said the new rule could "almost destroy" the sign shop at the State Prison of Southern Michigan in Jackson.

The sign shop and the metal industry at Jackson would be the only areas of Michigan's corrections system affected by the ban, he said.

"Probably two-thirds of that sign shop's sales are related to highway signs," Beetham said. "Probably 16 inmates might be laid off from their jobs because of it."

He said the law also could force the layoff of metal workers and civilian supervisors, and reduce sales by $300,000 to $400,000 a year since most state transportation projects involve federal financing.

"This contributes to increased idleness in the prison," Beetham said. "Idleness contributes to unrest and unrest contributes to rioting."

BEETHAM SAID the shop would continue making and selling signs as long as orders are placed. It will be up to clients to stop ordering signs for federally financed projects, he said.

Anthony Travisono, executive director of the American Correctional Association based in College Park, Md., said the ban on convict labor was sponsored by a road builders' group that had the phrase "or materials produced by convict labor" tacked on to a longstanding ban on inmate work on road construction projects.

"It was slipped through at the very last minute," Travisono said. "We weren't even conscious of it."

Travisono estimated that 37 states would be affected by the ban and about 4,000 inmates idled or reassigned because of the amendment backed by the American Road and Transportation Builders Association.

"They're gloating very much because they think they've done something great by returning jobs to people that are not convicts," Travisono said.

He said the correctional association would push to have the amendment repealed or modified.

Telephone calls to the builders association in Washington were not returned.

NO POSTAGE
NECESSARY
IF MAILED
IN THE
UNITED STATES

BUSINESS REPLY MAIL
FIRST CLASS PERMIT NO 1312 LANSING, MI

POSTAGE WILL BE PAID BY ADDRESSEE

Michigan State Industries
3222 S Logan Street
Lansing, Michigan 48910

Joyce Wills
Marcia Taylor

This pamphlet was left in hotel lobbies for distribution.

"You have tried the rest now try the best. Michigan State Industries has been manufacturing products since 1843. Our quality has withstood the test of time."

Says Howard W. Gentry, Deputy Director, Michigan State Industries

MICHIGAN DEPARTMENT OF CORRECTIONS

Bureau of Michigan State Industries

MSI Michigan State Industries Products Meet the Test of Your Institutiona

Administrative Furnishings

MSI office furniture emphasizes efficiency through simplicity. Choose from handsome hardwood furnishings or clean, strong metal designs. Fabrics and vinyl seating offer colors from subtle to bright.

- Desks
- Credenzas
- Book cases
- Executive office seating
- Office seating
- Vertical files
- Lateral files
- Conference tables
- Data-word processing furnishings
- Waiting room furnishings
- Partitioning system
- Typing tables
- Work surfaces
- Dining and lunch room furnishings
- Coffee bars
- Coat racks/hangers
- Vinyl 3 ring binders
- Data entry services

Institutional Furnishings

You are assured proven strength, durability, safety, and quality in every piece of MSI-built wood or heavy metal furniture and equipment. Most have been tested in Michigan's own correctional facilities and institutions. We are ready, now, to meet your needs in the following areas:

- Single beds, wood and steel
- Double deck beds, steel
- Cell furniture
- Lockers
- Dressers
- Mirrors
- Prison dining room tables and seating
- Chair, visiting room
- Bedroom desks
- Bedroom chairs
- Storage shelving, open and closed
- Interspring mattresses
- Box springs
- Gatch type hospital mattresses
- Janitorial products
- Soaps and detergents
- Brooms and brushes
- Latex paint

Finished Textiles

MSI's own looms provide fabrics which we cut and sew into handsome, durable clothing for men, women and boys. Select from work and casual attire, linens, leather goods and accessories.

Men's, Boys' and Misc. Clothing

- Work shirts
- Work trousers
- Inmate clothing
- Sport shirts
- Dress trousers
- Handkerchiefs
- T-shirts, white/colored
- Jockey and boxer shorts
- Leather belts
- Utility jackets
- Coveralls
- Surgeons' gowns
- Scrub shirt and pants
- Scrub gowns
- Technicians' jackets
- Physicians' coats
- Hospital bed gowns
- Laboratory coats
- Waiters' jackets
- Pajamas
- Shop aprons

Finished Textiles

- Cooks' aprons
- Men's hose
- Tube hose
- Sport tube sox
- Diapers
- Bibs

Women's Clothing

- Kimono style robes
- Nightgowns
- Dusters
- Jail and prison

Shoes

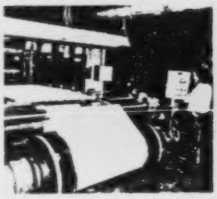
- Officers shoes
- Dress shoes
- Casual shoes
- Work shoes
- Safety shoes, hig
  low cut-
- Slippers
- Scuffs

Miscellaneous

- Mattresses and
- Bed pillows
- Blankets
- Bed sheets, flat a
- Hand towels, terry
- Bath towels, terry
- Table napkins
- Dish towels
- Hamper bags
- Laundry bags
- Mop heads

eeds, Your Budget

Raw Textiles

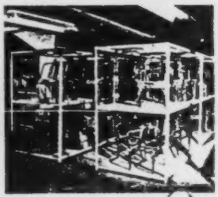


If you purchase raw textiles for cutting and sewing in your own industry system*, MSI can supply top quality material at excellent prices Out textile mill looms

- Cotton ducks, 8 oz and 10 oz
- Perma press 50/50 twills, colors
- Tubular knot goods, colors
- Terry toweling
- Wool blanketing
- Shirting, colors
- Sheeting, pastel colors and white
- Cotton blanketing

*Patterns available for T-shirts and jockey shorts

Other Raw Components



If you have assembly tions, MSI can supply components for certain office furniture which can be assembled at your location for added economy

- Work surface legs
- Formica tops
- Cushions, chair
- Chair frames, steel
- Airport seating frames and buckets
- Coat rack components
- Desk legs
- Coffee bar and base components
- Miscellaneous corrugated cartons
- Signs, highway and others
- Decals
- Office and desk signs
- Misc. leather products
- Clipboards
- Name tags

☐ ase send me your Michigan State Industries full color catalog and price list. I am interested in learning about how to purchase quality products tha will stretch my budget and save tax revenues.

For immediate assistance, call our sales dept. Area Code 517-373-6323.

Name

Title

Organization

☐ 501(c)(3) IRS approved Non-Profit tax exempt (Please submit verification with this card)

☐ x supported

Address

City

State Zip

( )
Telephone

msi
DEPARTMENT of C

ward W. Gentry, Deputy Director and Alvin L. Pickett, Sales Manager exhibiting Michigan State Industries manufactured products.

PRISON INDUSTRIES . . . MORE THAN LICENSE PLATES

Michigan State Industries (MSI) is a multi million dollar operation employing nearly 1,200 prisoners at 11 state prisons. Products and services are sold to tax-supported agencies and to nonprofit tax exempt organizations in Michigan and other states including the federal government.

The operation is run by the Bureau of Michigan State Industries under the direction of a Deputy Director and is self-supporting.

The goal of the industry program in the state's prison system is to provide meaningful employment and opportunities to learn usable skills for a significant number of prisoners.

To that end, a four-year apprenticeship program culminating in a certificate and journeyman status, is offered in tool and die, drafting, industrial maintenance, electrical and in machine repair at the State Prison of Southern Michigan at Jackson.

Alvin L. Pickett, Sales Manager, Michigan State Industries explaining quality and cost to potential customers.

Michigan State Industries has exhibits at many trade shows throughout each year.

Now Strong, Safe, Economical MSI Products Can Meet Your Needs, Too.

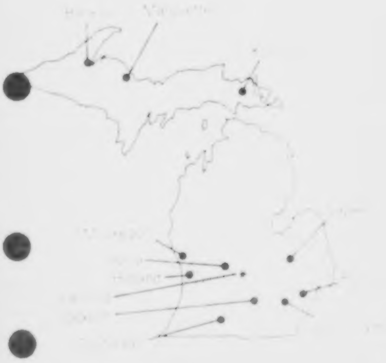
Michigan State Industries, a Bureau in the Department of Corrections, markets products to any tax supported agency in this or any other State, the Federal Government or any non-profit organization that is tax exempt under Section 501(c)(3) of the Federal Internal Revenue Code.

24 factories provide products and services from 11 locations. As a customer of MSI, you become an active participant in a rehabilitative program where inmates learn marketable work skills, and work habits which help them prepare for their return to civilian life.

Craftsmanship comes fro awareness that the produ inmates produce are valu in the marketplace. Combin with the dedication of ou civilian supervisory staff ar work pride is your assuran of the highest quality products that will stand t test.

Return the attached business reply card for our complete catalog ar price list.

MSI Factory Locations



● — FACTORIES
• — LANSING OFFICE

PRISON INDUSTRIES OPERATIONS

Description

The Bureau of Prison Industries operates 14 plants and six service programs that provide products and services to state and local government agencies and other organizations and offer work experience and a source of income for inmates at the Jackson, Marquette, Muskegon, Ionia Reformatory, and Huron Valley Men's and Women's facilities. Products and services include office furniture, vinyl products, highway signs, license plates, clothing and textiles, innerspring mattresses, shoes, laundry, maintenance, machine shop, and warehousing. The cost for civilian personnel, all of whom are supervisory, is appropriated annually while all other costs are charged to the Industries Revolving Fund. The objectives are to teach prisoners salable skills, improve prisoner self esteem and work habits, and relieve boredom and idleness in the prisons.

Measures

Michigan State Industries
Employment Measures

Institution	Participants Per 100 Prisoners	Number of Participants	Percent Working Full Time	Average Length Of Time
SPSM COMPLEX (Central, North, South), (Pop. 4406)	7.4	592	100%	6 mo.
MARQUETTE BRANCH PRISON (Pop. 504)	10.5	53	100%	6 mo.
HURON VALLEY WOMENS FACILITY (Pop. 363)	7.7	28 (50 Proj.)*	100%	N/A
REFORMATORY (Pop. 1086)	21.0	223	100%	8.5 mo.
MUSKEGON CORRECTIONAL FACILITY (Pop. 589)	4.0	25 (Proj.)*		
HURON VALLEY MENS FACILITY (Pop. 396)	5.0	20 (Proj.)*		
DEPARTMENTWIDE (Avail. 7344)	7.6	963 (Proj. Total)		

*These programs are expected to be fully operational by the fall of 1985.

CITY [illegible]AL OAK

TABULATION OF BIDS

REQUISITION NO.:

PURCHASE NO.:

DEPARTMENT: Public Works

DATE OF OPENING: 4-8-83

ITEM	BRIEF DESCRIPTION	MI State Industries Jackson UNIT PRICE	American Highway Longmeadow, MA UNIT PRICE	Newman Signs Jamestown, ND UNIT PRICE	U.S. Standard Si Toledo, OH UNIT PRICE	Paul Mack Signs Muskegon, MI UNIT PRICE	Hall Signs Bloomington, IN UNIT PRICE	AMOUNT OF ITEM AWARD	REMARKS
	ALUMINUM SIGN BLANKS								
25	36 x 48 Blanks - Stamped	23.38	14.31	18.30	14.87	20.01	14.21		
	Top and Bottom								
.00	24 x 24 Stop Sign Blanks	7.79	4.40	6.25	4.65	6.41	4.25		
	TOTAL	1129.70	797.75	1082.50	836.75	1141.25	780.25*		
	Blanks to be Alodine 1200								
	Coated: Gauge .080 thickness;								
	Standard stamping top and								
	bottom; and to accept Engineer-								
	ing Grade Sign Faces that								
	are reflective.								
	Firm For:	60 da.	30 da.	30 da.	30 da.	120 da	30 da.		
	Terms:	net 30	net 30	net 30	net 30	net 30	net 30		
	Delivery Date:	30 da.	30-45	30 da.	30-45	30-45	4 wk.	shipping	

REMARKS:

* All or none

NO BIDS were received from Callender & Dornbos, Inc.
Vulcan Signs & Stamping
Bemis & Sons, Inc.
3 M Company

AWARDED BY:

PREPARED BY: Thompson

State of Michigan

James J. Blanchard, *Governor*
Department of Corrections
Stevens T. Mason Building, Lansing, Michigan 48909
Robert Brown Jr., *Director*

Corrections Commission
Gwen Andrew, Ph.D.
Brunetta Brandy
Thomas K. Eardley, Jr.
James H. Lincoln
Duane L. Waters, M.D.

JAN 14 1985

FOR IMMEDIATE RELEASE

Jan. 8, 1985

Howard Gentry, vice president of the Warren Real Estate Group of Lansing, has been hired by the Michigan Department of Corrections to direct its $13 million prison industries operation.

Gentry, 54, of St. Johns, succeeds Frank W. Beetham, who retires on Jan. 12. Gentry begins his duties as a deputy director today.

The appointment of Gentry was made by State Corrections Director Robert Brown, Jr., who said:

"One of my chief goals as director is to expand prison industries so we can hire more prisoners and teach them better work habits and attitudes. In addition, our modern production methods should give them very marketable skills to use when they leave prison. We've made much progress in modernizing and expanding the operation during Mr. Beetham's tenure, but I'm sure Mr. Gentry will carry the program even further."

Gentry has been with Warren Real Estate Group since 1980. In his position as vice president he was responsible for the construction of multi-family housing in Michigan, Indiana, Kentucky, Georgia, Virginia and Florida. From 1977 until 1980, Gentry was group vice president for Excel Industries in Elkhart, Ind. Excel manufactures automotive and recreational vehicle windows.

While with Excel, Gentry opened a new plant and launched seven new products for automakers. He also worked for ITT Thompson Industries of Southfield from 1967 to 1977. His last position there was as regional manager for the metals division. He also was division manager for the plastics division.

Beetham, 62, has been deputy director in charge of the industries program since 1972. Under his direction, the operation has expanded from gross annual sales totaling about $3 million to nearly $13 million. He has expanded the program from its original three prisons to five and has worked to make the operation nearly self-supporting.

The department has operated factories within Michigan prisons since the early 1920s. Currently the department employs about 1,000 prisoners at five state prisons. Products and services are sold to tax-supported agencies and to nonprofit tax exempt organizations in Michigan and other states including the federal government.

Among the products made by Michigan prisoners are textiles, metal furniture, road signs and decals, shoes, steel frame chairs, wood furniture, inmate clothing, cotton garments, vinyl-covered three-ring binders and license plates and tabs.

Prisoner employees are paid an average of $4.35 a day and can earn bonuses during quarters in which a profit is shown.

STATE OF MICHIGAN

WILLIAM G. MILLIKEN, Governor
DEPARTMENT OF ADMINISTRATION
STEVENS T. MASON BLDG., LANSING, MICHIGAN 48913
WILLIAM N. HETTIGER, Director

April 12, 1971

ADMINISTRATIVE CIRCULAR NO. 12

TO: All State Departments

FROM: William N. Hettiger, Director

SUBJECT: Michigan State Industries Products (M.S.I.)

The Executive Office and this Department are directing all departments in state government to fully utilize the products manufactured by Michigan State Industries. This is not only important from an economical standpoint but for the rehabilitative employment opportunities it provides in state correctional institutions.

Each department will be required to use M.S.I. products whenever feasible and economical. No article, which in essential specifications or quality is manufactured or produced by Michigan State Industries, will be purchased by any state department from any other source except M.S.I., unless that article cannot be delivered by M.S.I. within a reasonable period or that such purchase would not be in the economical interest of the State.

Such orders for articles of supply and equipment shall be by inter-departmental purchase order to Michigan State Industries, Department of Corrections.

Each department and the Department of Administration will be responsible for enforcing the provisions of this directive.

This directive will not preclude the procurement of articles manufactured or repaired by the Institute for the Blind, Department of Social Service.

Administrative Circular No. 72, dated February 8, 1962 is hereby cancelled.

The effects of state government competing against private enterprise ha~~s~~ve come to a head now that there is recognition of the fact that when the state government provides certain services "inhouse," not all of the costs are factored in. As a result, the state government competition is unfair to the private sector because of lowered costs as shown on paper. It increases the total cost of business because of an increase in needed revenues to the state government General Fund to make up the difference in these cost factors. As an illustrative example, consider the following case:

A printing business doing one million dollars in total volume of work can do $600,000 of printing business for the state government and an additional $400,000 in the "bridge time" when the state government needs for printing are slow, such as when the legislature is not in session.

Business Volume	$1,000,000
State work	600,000
Taxable labor (based on 30% of the $600,000 of state work.	190,000
4.6% income tax on labor for state printing needs	8,740
4% state sales tax on $400,000 worth of additional printing business	16,000
Property tax	7,500
State sales tax on utilities provided to private enterprise.	5,000
Single Business Tax*	5,123
Total tax revenues to Michigan State government.	42,363

*Single Business Tax computation:

Profit on business at 8%	80,000
Labor expense per 30% labor on state work.	190,000
Single Business Tax exemption per business	40,000
Single Business Tax exemption per one partner.	12,000
Single Business Tax base	218,000
.0235 Single Business Tax percent	5,123

Drain on Michigan state government budget as a reflection of cost factor when state government competes against Michigan's private enterprise:

Machinery duplication expensed in government budget ($300,000 worth of machinery good for ten years)	$ 30,000	per year
Buildings owned and leased by the state government, (30,000 square feet at $30 per square foot, for 20 years)	45,000	per year
Maintenance of equipment and property (2.5% of the total dollars for equipment and the building)	1,875	per year

Total cost of duplicating efforts of private enterprise (not included: prorata increased cost of additional administrators in the state government and increased salaries of top echelon executive administrators because of increased number of state government employees under their supervision.)	76,875
Cost to state when printing done by private enterprise	600,000
Cost for labor and materials when printing done inhouse by Michigan State government	525,000
Paper "profit" for state government when printing done inhouse	75,000
Expense to state government for duplication of equipment and property	76,875
Lost revenues to state government from lost taxes	42,363
Total real cost to state government	119,238
Paper profit	75,000
Real costs	119,238
Real cost to the State of Michigan for doing printing work inhouse	44,238

This illustration is conservative in favor of the work being done by state government. The fact is that buildings, utilities, administration, transportation costs, insurances, and the like are not considered when the state government bids work in competition with private enterprise. Nor is the expenditure for such taxes as the Single Business Tax, sales tax, income tax, etc., which generate money for the state government, factored into the "sales price" of state government work. It is no wonder that state government can "beat private enterprise" when bidding against it.

Consider the long-term damaging effects: The more people that are on state government rolls, the higher the taxes must be in the state while at the same time, there are fewer opportunities for businesses and jobs in the private sector to generate these taxes. While Civil Service employees pay state income taxes, these taxes amount to a payback of a percent of state funds. In that respect, the taxes paid by state government employees are really a reduction in the drain on state coffers and not a contribution to the state's total budget revenues.

In the more long-term view, consideration must be given to the growing concern about the state government's ability to fund the pension plans for state government employees. The more employees are dependent on that plan, while at the same time there are fewer revenue producing businesses and jobs in the private sector, the greater will be the inability of the state to manage its responsibilities to its employees.

In the September 16 issue of MSEA NEWS, there was concern voiced that a reduction in the amount of work done by the Civil Service employees might subvert the collective bargaining process and lead to widespread political corruption with state jobs parcelled out according to who, not what, a job applicant knows. If state government program administrators are honest now, they can be just as honest in making sure that jobs provided to the state by the private sector will remain honest.

On a more human note, considering another article in the September 16 MSEA NEWS, with the headline, "Employees have 'given' $99,000," meaning state employees have helped support the state's economic problems by giving up some of their compensation, consider the prospect of the near future and the distant future of holding out the promise that the state government of Michigan can provide a safety net for Michigan's citizens by taking over manufacturing, production, and service industry functions from the private sector. The arithmetic says that it cannot be done. The state needs private industry and jobs in the private sector, (1) to generate revenues for the state government to provide its legitimate governing functions and, (2) to avoid closing the opportunities for a job that can generate the revenue for a quality livelihood and, thus, keep people off the welfare and unemployment rolls. To think that the state government can do everything and still provide for the people that the government is supposed to be serving is a myth. Your children and grandchildren are going to be greatly disappointed if they expect the state government to guarantee a livelihood for them at the expense of private enterprise. The promised safety net of state government won't be strong enough to catch them and hold them after they have already jumped.

MANPOWER®
TEMPORARY SERVICES

July 6, 1981

In regard to our conversation on Wednesday, I would like to reflect on what our position with the State of Michigan has been for the past several years.

About eight years ago, the State of Michigan, Department of Management and Budget decided to operate TOPS - Temporary Office Personnel Services. Prior to the inception of TOPS, many department heads and managers utilized our service and were extremely satisfied. An audit of our appraisals (a system whereby each and every job assignment and employee is appraised and evaluated) revealed the satisfaction of the managers involved. I am attaching a copy of our appraisal system.

From the time TOPS was instituted, it has been virtually impossible to discuss our service with any or all department heads even though the majority indicate a preference for an outside service, naming Manpower Temporary Services as very reliable.

Some of the positive responses have been the quality of the temporary, the professionalism of our service and its dependability, the cost effectiveness, to mention the major reactions.

With all the positive imput, the managers and department heads felt their managerial descretion was inhibited by the limitations placed on them when the State of Michigan and Civil Service mandated they call upon TOPS for any and all temporary positions...Period.

During the time we have been occasionally called upon by TOPS when their register has been depleted or they cannot fill a particular position. The same positive responses prevail. However, managers are somewhat unhappy and disillusioned with TOPS as it is our understanding that TOPS rebills the department at an increased rate over and above our rate. Again, the limitation on management prohibits them from running the most cost effective and efficient department.

In further discussions with managers regarding the ruling on TOPS, we found a noncommittal attitude surfaced: "Why make waves, it's not worth the effort." Yes, even though our service is preferred over TOPS in the majority of situations, the ruling remains without challenge.

This industry believes implicitly that the provision of temporary help services are best and most economically provided by the private sector when initiative and the discipline of a competitive market place ensures the provision of a cost-effective service to each and every user including the various governments. We know that by the State of Michigan maintaining a program of providing temporary help for their departments, there has been either no audit of the function performed to determine the true cost of providing such services, or else the results have not been made available to the public. We have tried numerous times to get this information, each time with little success. I might add private enterprise knows the true cost of doing business in the temporary help industry. Please let me know if this vital issue needs expansion.

The State of Michigan and Manpower seem to agree on two major factors: that temporary services are an economical and efficient means of implementing certain staffing requirements, and that the increased mobility of the nation's work force has imposed new staffing demands on business, industry and government.

What we seem to disagree upon is the necessity of a manager to determine when he needs temporary help, and where he can get the best results to fill his or her particular needs.

In conclusion, we would like to underscore the following views:

a) Giving the State of Michigan the task of administering temporary help services adds unnecessarily to the tax burden. Furthermore, we believe it entirely unlikely that government (or any other public or non-profit organization operating without competition) could provide service as efficiently and as economically viable as the private sector.

b) Employees of temporary help services receive wages consistent with the market for their particular skills and experience. Those who remain on temporary assignments receive regular increases and reclassification as their skill and experience warrant.

c) Temporary help employees choose employment for a wide variety of reasons - to subsidize education, supplement family or retirement income, or finance special wants and needs.

d) The temporary help employer faces the same direct and indirect costs of providing jobs as does every other employer in government, industry, and commerce.

e) The temporary help service industry exists because users need temporary help services for a variety of reasons, such as seasonal work, peak workloads, vacation fill-ins, temporary replacements for sick employees, and a variety of relatively short, special assignments which the user's own employees may be unable to perform.

f) The customer or user not only has no responsibility for the temporary employee beyond the length of the assignment, he does not have to mount a recruiting program, interview, screen, or select employees, or in any way be concerned with the administration of wages and the worker requirements.

g) The temporary help industry provides performance guarantees providing that if the user is not satisfied with the services of the temporary help service, he is not billed for that service. But the employee is always paid in full.

h) The user of temporary services pays a charge for such services at rates that include the employee's wages, fringe benefits, the employer's costs of administration, overhead, and a small allowance for profit. The method of operating is no different than any other industry and might be compared with electrical and plumbing contractors, accountants, consultant firms, security services, etc.

Manpower welcomes the opportunity of presenting the facts about our position with the State of Michigan and about the operation of the industry to you. We are available for further comment and would welcome any meeting or open discussion of this matter.

Yours truly,

MANPOWER TEMPORARY SERVICES

Carolyn Domagalski
Vice President

Enclosure

McKAY
GOLF & COUNTRY CLUB PROPERTIES

Tom. Wilbur,
4871115
(Called for McKay)

December 17, 1981

CECIL R. McKAY
CECIL R. McKAY, JR.
Brokers

RICHARD A. GROSSNICKLE
Consultant - Representative

DOROTHY A. RICE
Executive Secretary

Mr. Doug Finley, Director
Lansing Dept. of Parks & Recreation
Fourth Floor, City Hall
Lansing, Michigan 48933

Dear Mr. Finley:

I would like to outline briefly our ideas in connection with the Lansing city golf courses. We would emphasize two points:

1. According to National Golf Foundation statistics, an average daily fee golfer in this area plays 34.5 18-hole rounds of golf per year. This means if the Lansing courses produce 180,000 9-hole rounds (80,000 18-hole rounds), they can accommodate approximately 2,600 golfers. When we assume that at least a fair percentage of these golfers are non-residents, the burden of expense (or loss of revenue) falls on a very large percentage of Lansing city residents. A lease would not remove the golf recreation from the 2,600 golfers, and would provide funds for recreation for the other 90%+ of Lansing residents.

2. The city would not be disposing of the golf courses, they would be putting them under the operation of a concessionaire. They would still be municipal courses. The leagues and programs currently in effect at the courses could, most likely, be kept intact and operated by the lessee. We feel that a contract could be negotiated that would allow special rates for residents and senior citizens.

The big advantages in a private enterprise operation of the courses would be:

Service: We would anticipate a lessee providing a more personalized service, including longer hours of operation for cart rentals and concessions.

Funding: The Park Board would be relieved of overhead pertaining to golf, such as accounting, security, utilities, December 17, 1981

Mr. Doug Finley
page 2

insurance, trash and garbage disposal and other items that do not directly show up in the golf operations budget. On top of this savings, we would anticipate something in excess of $150,000 to be derived from the lease rental of facilities. These funds could be used for either lowering the Parks Department budget or for creating better programs that could benefit greater portions of the Lansing population.

We feel strongly that the overall effect would be to provide a quality golf program and also allow enhancement of other programs within the city. Another side benefit of this might be income tax derived by the city from the lessee.

Our lease proposal is in a rather formative state at this point, but we feel initial investigation might be along the following lines: -

Lessee would enter into a "net-net" lease, paying an amount based on rounds of golf, such as $1.00 per 9-hole round.

Lessee might buy the maintenance equipment from the city, then give a security agreement back as guarantee for the lease.

An agreement for annual inspection could be included which would provide insurance against declining condition of the premises.

A clause might be provided to allow for capital improvements.

Lessee could agree to provide special discount rates for residents and senior citizens as required.

We might suggest the following plan of action to proceed: -

1. Make a feasibility study of the golf courses to show assets included, type of equipment, operational procedures, and a projected budget for a proposed new operation. This study would give a better idea of what anticipated lease income would be and what savings to the Parks Department.

December 17, 1981

Mr. Doug Finley
page 3

A feasibility study would be essential in negotiations with a potential lessee. This study could be done by the Parks Department or by an independent agency. If McKay Golf Properties made the study it would cost approximately $6,000.

2. If the city decided to enter into a lease, bids could be invited; and, through an interview process, a lessee found. If the service of McKay is desired, we would find a qualified lessee for 5% of the net lease.

A summary of McKay's qualifications in the golf business would be:

A book written on golf course valuation for A.I.R.A.
Instructor at an International Seminar for A.S.P.
Taught seminars for State of Michigan Tax Assessors Board.
Taught various other seminars for M.S.U., Purdue University, Ohio State, Ferris State, Florida Golf Course Owners, Indiana Golf Course Owners, National Golf Foundation, Golf Course Superintendents of America.

We stand ready to be of service in whatever capacity the city might choose.

Sincerely,

McKAY GOLF & COUNTRY CLUB PROPERTIES

Cecil R. McKay, Jr.

d

cc: Mayor Elect Terry McKane

Sent to: All Public
Officials, News Media
Golf Clubs, Etc

Written
By

April 9, 1980

BAIL OUR GOVERNMENT OUT OF DEBT!

This is a time when every newscast and casual conversation in the coffee shop is filled with concern for our economy. Our public officials are fighting to find new sources of revenue, counties and cities are going bankrupt, and, yet, some basic solutions are ignored.

* In Lansing, Michigan *

The Parks and Recreation department is operating a $5.5 Million budget which must be paid by the taxpayers of the community. Included within it are four golf courses operating with unrealistically low fee structures. Green fees in the Lansing area should be at least $7.50 to $8.00 for 18 holes and $4.00 to $4.50 for 9 holes. The parks department is currently charging $6.00 for 18 holes and $2.50 to $3.00 for 9 holes.

THE PROBLEM CREATED IS THREE FOLD:

1. The low fees charged are eliminating a badly needed source of income for the city (at a time when the Mayor is suggesting an increase in taxes may be required).

2. The golf courses are being subsidized and supported by 100% of the population through their taxes, yet they service less than 5% of the people. For example, National Golf Foundation statistics regarding our area show the average municipal golf course produces 44,418 18-hole rounds of golf per year, and the average number of rounds played by each golfer is 34.5. This would mean that 1,287 individual golfers would fill an 18 hole course. It also means that Lansing's total of 54 holes of golf can accommodate 3217 1/2 average golfers. Quite a number of these people probably do not even pay taxes to the city.

3. The low golf fees charged by the Lansing parks system have forced a lower fee structure in the privately owned public courses that exist in the area. Most privately owned area courses are charging $7.00 green fees for 18 holes. These

privately owned courses are paying taxes to support our government and, therefore, tend to help support their underpriced competition, the city owned courses. If this unnecessary government competition did not exist, the privately owned courses' tax contribution would be higher.

* What are other areas doing? *

In California, under Proposition 13, many municipalities are leasing out their golf facilities to private business concessionaires, thereby taking an entity that created an expense and turning it into a revenue producing facility.

Here in Michigan, Oakland County Park District has three 18 hole golf courses plus one 9 hole facility operating at a profit. They charge $8.00 to $9.50 green fees for 18 holes. Their county park district operates on 1/4 mill taxes which provides them with approximately $2.5 Million in revenue. This is less than 1/2 of the $5.5 Million budget here at Lansing.

* A Solution *

One of the first things needed is for the parks and recreation people to find out what the true costs of operating and maintaining their golf courses are. Any expense estimate should not only include direct costs, such as:

Salaries and wages, along with fringe benefits
Operating supplies
Utilities, including city sewer and water
Equipment maintenance and leases
Improvements
Cost of goods sold

but also indirect costs, such as:

Tree trimming (by Forestry Dept.)
Fence repair and maintenance
Security department (for picking up cash)
Bookkeeping and clerical costs
Police and fire protection
Finance, auditing, and government overhead

There is no reason why the Lansing Parks Department cannot operate their golf facilities profitably and there is no reason why golf fees cannot be increased right now or even after the golf season starts.

* We would like to have answers to these questions *

QUESTION: Why is our government providing subsidized services in competition with private industry?

QUESTION: Why must 95% of our population be overtaxed to support recreation for the other 5%?

QUESTION: Why is property that is potentially revenue producing not only being taken off the tax rolls, but also being used in a manner that required the taxpayers to subsidize it?

QUESTION: Why should the Lansing citizens pay higher millage and income tax to support recreation for less than 5% of the population?

Your help in alleviating this situation will certainly be appreciated. Let's follow Oakland County's lead and require the Lansing golf courses to compete fairly and operate profitably.

Sincerely,

LANSING AREA CONCERNED MEMBERS
OF M.A.P.G.C.

162 Holes 13 Members
18 Non Member
[illegible] 3 Private Clubs

Royal Scot Golf Course
El Dorado Golf Course
Highland Hills Golf Course
Branson Bay Golf Course
Centennial Acres Golf Course
Perry Glenbriar Golf Course
Pine Hills Golf Course
Oak Lane Golf Course
Prairie Creek Golf Course
McKay Golf & Country Club Prop.
Bennington Golf Course
Chardell Golf Course
Pine Lake Golf Club

M.A.P.G.C. (Michign Association of Public Golf Courses) represents the 432 daily fee golf courses in Michigan which are a major economic industry in the state; in fact, Michigan has more daily fee golf courses than any other state. Let's help keep us #1.

Additional copies available on request.

Non Memb
18 [illegible]
18 [illegible]
9 Troy Hills
9 [illegible]
18 [illegible]
17 [illegible]
9 [illegible] View
18 Chisholm
9 Indian Hills

November 17, 1981

Mayor-Elect Terry McKane
City Hall
Lansing, Michigan 48933

Dear Mayor McKane:

Congratulations on your election!

I have a rather abbreviated, but very serious, proposal here. It needs some quick action, and if you are interested, I would like to meet with you or someone on your staff to discuss it.

We are talking about the possibility of leasing all or part of the Lansing City Golf Courses, namely Groesbeck, Red Cedar, Sycamore, and Waverly, to a private golf course operator. Our proposal, briefly, with the details to be worked out would:

1. Provide the city with some instant cash through the sale of the golf course maintenance equipment to the Lessee.

2. Provide the city with additional annual revenues of, perhaps, $150,000 on a net lease.

3. Relieve the city of the burden and losses they now have in the operation of the golf courses, and at the same time provide more efficient and desirable golf course operations.

We have the expertise to work out such an agreement and we have the clients to make a proposal to. We have, in particular, one prospective lessee from the Detroit area with an immediate interest.

It is very important to work out a program in the Fall, so that when the courses open in the Spring, the proper supplies, programs, rates, etc. can be in effect.

Many government agencies are now going to the lease concept in order to streamline their operation, reduce costs, and produce income.by letting the free enterprise system operate the facilities they are better suited to operate.

I hope to hear from you soon.

Sincerely,

McKAY GOLF & COUNTRY CLUB PROPERTIES

Cecil R. McKay, Jr.

d

City of LANSING

LANSING, MICHIGAN
487-1270
48933

PARKS AND RECREATION
CITY HALL—4TH FLOOR

February 12, 1982

Mr. Cecil McKay, Jr.
15553 North East Street
Lansing, MI 48906

Dear Mr. McKay:

The Park Board reviewed your letter at their January Board Meeting and has asked that I forward the accompanying correspondence to Mayor McKane, with a copy to yourself.

The Park Board is currently examining the fee structure for the golf courses and is therefore looking at the policy issue of whether the golf courses should cover the direct costs, whether they should be totally self-sufficient (including indirect costs and/or service fees they would pay if not governmentally operated), or if fees should be developed on a maximum profit basis. Again, this decision has implications as noted in the interoffice to the Mayor.

Thank you.

Sincerely,

Douglas Finley

Douglas Finley, Director
Department of Parks & Recreation

/de

RECEIVED
FEB 16 [illegible]

City of LANSING

INTEROFFICE COMMUNICATION

TO: Mayor Terry McKane

FROM: Douglas Finley, Director, Parks and Recreation DATE: January 22, 1982

SUBJECT: LETTER FROM McKAY IN REGARD TO LEASING GOLF COURSES

Following our meeting with Cecil McKay, Jr. I received a letter (you were carboned) in regard to leasing Lansing's four golf courses. I discussed this with the Park Board and they have asked that I correspond with you and send a copy to Mr. McKay.

Lansing golf courses have historically been operated as a service to the community, and generally in a cost-effective manner. It has not been the objective of Lansing to gain maximum revenue above expenses or to have the courses subsidize other City services. Fees have therefore been based on covering direct budgeted costs. To date the Park Board has not recommended, nor has the Council enacted a fee policy which would cover all indirect costs, (costs of other City departments processing payrolls, auditing, purchases, etc.), nor have they established a policy which would go further and operate the courses on a maximum profit basis. With current economic conditions this position may however change.

If at some future point the City should wish to generate maximum revenue we would simply modify a number of services we provide and increase the fees. Once operating under this direction we would have an actual history of our profits and expenses, and with that we could make a comparison with the alternative of leasing golf courses. If at that point we felt that the courses could be operated equally as well, and at greater revenue, then leasing would be seriously considered.

It is the Park Board's position that this matter not be pursued at this present time.

If you have any questions about this please contact me at your convenience.

/ls

cc: Cecil McKay, Jr.
Park Board

MICHIGAN ASSOCIATION
PRIVATE CAMPGROUND OWNERS
P.O. Box 160, Metamora, MI 48455
313-678-2652
Randall Whitsel
Executive Director

1984 MAPCO OFFICERS & DIRECTORS

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517-652-5666

Ralph Wiggers, Vice President
Three Braves Campground
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Buchanan, MI 49107
616-695-9995

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Flint/Otter Lake KOA
12260 Farrand Rd.
Otter Lake, MI 48464
313-793-2725

Bill Holz, Treasurer
Tall Timber Campground
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Mears, MI 49436
616-873-4502

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Belmont, MI 49306
616-361-1053

Phil Brink, Director
Paradise Cove Travel Trailer Resort
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Sand Lake, MI 49343
616-866-1415

Ray Crots, Director
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US 23 at Summerfield Rd.
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517-939-8723

Don Wilson, Director
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616-256-7236

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West Wind KOA
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616-857-2528

Jim Cordray, Executive V.P.
White River Campground
735 Fruitvale Rd.
Montague, MI 49437
616-894-4708

Al & Elaine Rogers
Campers Association
1326 Jeffery St.
Ypsilanti, MI 48917
313-482-5198

Dennis Leonard
N.C.O.A. Regional Rep.
St. Clair Wilderness Campground
P.O. Box 147
St. Clair, MI 48079

August 27, 1984

Mr. Curtis Fuller
Woodalls Publishing Co.
500 Hyacinth Place
Highland Park, Il., 60035

Dear Mr. Curtis:

Thank you for requesting information in your July 2nd., letter, for information on public and private competition in camping for your September 28th., talk to the National Association of State Park Directors. I have been giving your request some serious thought as I have been visiting over 300 private campgrounds in Michigan this year.

In Michigan, State Parks, State Forest (primitive), Township Parks (modern and primitive), and National Forest Service Campgrounds (primitive), all compete with the private owner for campers. They unfairly compete with the private owner in a number of instances please let me enumerate:

1. They occupy choice pieces of property, either given to the State or bought with tax supported revenue.

2. Their rates do not adequately reflect the cost of investment of these choice pieces of property, capital investments, in buildings and operating costs. This keeps rates artifically low and creates a "price war" with which many private operators who must show a profit and a fair rate of return on investment to stay in business, cannot compete. Hence, in Michigan, the average turnover of private campgrounds is once every 3 - 4 years and only 10 - 12% of private campgrounds that are self supporting.

SAY YES M!CH!GAN CAMPING!

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Dennis Leonard
N.C.O.A. Regional Rep.
St. Clair Wilderness Campground
P.O. Box 147
St. Clair, MI 48079

3. In Michigan, State Parks, State Forests, Township Parks, and National Forest Campgrounds are given an unfair advantage by the Michigan Department of Transportation. Although the present guidelines for Traffic Generator Signs, adopted in 1980, do allow private campgrounds who qualify to have such signs erected, they have not been enforced. (Only 2 or 3 private campgrounds in the entire state have had one erected even though many owners who qualify have applied and even offered to pay for signing.)
However, *almost every* State Park, State Forest, Township Park, and National Forest Campground in our state is given a similar sized sign or larger in the case of some of the more popular State Parks. It is especially incongruous to note that while traveling in the Upper Pennisula the last two weeks where the camping industry *depends almost soley* on the tourist, I noticed National Forest Campgrounds providing only the *barest* of essentials; picnic table, hand pump well, and pit toilets, will have such a sign while a private campground offering; flush toilets, hot showers, and other more modern and desirable amenities *cannot even qualify* (by the traffic count criteria) for such a sign.
4. When it comes to competition there is one further "grey area" in Michigan, and that is the Health Department regulations and inspections. We find that in some cases State Parks do not meet the code and the same standard enforced on the private owner. Because of the "fraternal" relations of one state agency (or governmental agency) to another and "budget require-

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ments", State facilities are not made to conform as quickly as the private campground owner is. The private campground owners are given a choice, either conform and invest even more of their hard earned dollars to meet the requirements immediately, or lose their license. There is much more leniency afforded "brother" state institutions which one high ranking Health Department official has readily admitted to myself.

I hope this gives you some help in planning your talk. We appreciate what Woodalls Publishing attempts to do for the private campground owners.

Your Michigan representatives, Vern and Marion Jordan, are spoken of quite highly wherever I go. They deserve your commendation for being quality representatives of Woodalls.

If I can be of further help, please feel free to contact me.

Sincerely;

Randall Whitsel

Cc: Gov. Jim Blanchard, M.D.O.T. Dir., Jim Pitz, DNR Dir., Dr. Ronald Skoog, Rep., Tom Alley, Sen., Ralph Gerson, Dir. Dept. of Commerce, Board Members

SAY YES M!CH!GAN CAMPING!

WHITE RIVER CAMPGROUND

[illegible]

February 10, 1981

PUBLIC VS PRIVATE

CAMPGROUNDS - - Capitalized by all taxpayers thru Federal and State. Approximately 20% of population are campers. Public campgrounds operate at loss in many instances thus subsidized by taxpayers. When public campgrounds do figure to charge enough to break even, they don't include cost for replacing equipment and buildings plus they don't have to pay property taxes equal to the private campgrounds. Public campgrounds usually undercut private campground fees because of their cost not including property taxes and depreciation, some advertising and little or no cost for miscellaneous labor furnished by other government sponsored programs.

Specif
State
+
Michigan
Campg

SOLUTION - - No federal or state funds to be used to build any public (or municipal) campgrounds. Existing state and public facilities be required to charge a user fee large enough to cover all operational costs including replacement costs, property taxes as the private campground must charge so as to survive.

MARINAS GOLF COURSES SIGN SHOP

PRINTING SHOPS

Any recreation maintenance that can be feasibly contracted by the private such as snowmobile trail grooming, road construction etc.

Jim [illegible]

TALL TIMBER CAMPGROUNDS

RR1 MEARS, MICH. 49436 PH. (616) 873-4502

March 30, 1981

Ms. Marty Andrews
Mid-Michigan Stamps & Signs, Inc.
400 N. Larch Street
P.O. Box 20096
Lansing, MI 48901

Dear Ms. Andrews:

We are located near Silver Lake State Park Campgrounds and greatly appreciate the excellent cooperation and friendly relations we enjoy with park personnel during the summer months when the campground gate is attended. In the early spring, fall and winter, however, we object to the fact that the state park campground gate is not attended, although the campground is open. During these slow camping periods some campers camp free by arriving after the park attendant has made his rounds and leaving before he checks the park for the next day. This presents us with unfair competition because we cannot afford to allow free camping in our campground.

We initially discovered that people were camping free in the State Park in the fall when several campers came to our campground to get firewood for their campfires. They told us they were camping at the state park free. At about 9:30 PM Saturday night, March 28, 1981, we again noted that there were four camping units at the State Park Campground. On Sunday, March 29, 1981, about noon, we drove through the camping area and noted that only two of the four units had cards with 29 written on them to show that they had rented their campsites. The other campers, who had no record of registration, were getting ready to leave. We would greatly appreciate it if the State Park Rangers would attend the gate when the park is open for camping and close the gate when it isn't. If this isn't possible, they should frequently patrol the area to prevent people from camping free.

Sincerely yours,

Bill Holz

ENERGY PICTURE BRIGHT FOR SUMMER - Michigan's Public Service Commission and the State Energy Administration report that gasoline, fuel oil, natural gas and electricity will all be in ample supply this summer. Michigan's gasoline consumption, according to Energy Administration, is expected to be just under 4 billion gallons for 1982. That is a decline of almost 1 billion gallons of gasoline since 1978. Conservation, higher prices, and fuel-efficient automobiles are responsible for the dramatic dip in gasoline consumption.

WELFARE CASELOADS DECLINE - There were fewer recipients of A.D.C. and general assistance during the month of May than in April, a month which also saw a decline in welfare applicants. There were 229,710 cases in May, down 2,198 from April; general assistance dropped 235 cases to 106,740. ADC-U caseloads (families that have exhausted unemployment benefits) fell by 1,089 cases in May to 41,410. The figures were compiled by the Department of Social Services.

RENT-A-TENT - The Department of Natural Resources Parks Division is making available rental equipment at three state-maintained recreation areas. Brighton Recreation Area (313) 229-6566, Holly Recreation Area (313) 634-8811, and Fort Custer Recreation Area (616) 731-4200, have 15 tents and 30 cots and foam pads ready to be rented, but you must call in advance. If the program proves successful, more parks will feature the rental plan next year. The cost of the rental equipment will be paid off by the end of the summer from the rental fees. Say "Yes" to camping in Michigan!

PARADES, FESTIVALS AND FAIRS - The Muskegon Seaway Festival Parade will be held in downtown Muskegon June 26. The Festival runs until July 4; "Spree 32" Celebration, Ford Field, Livonia, June 21-27; Glen Arbor Daze, June 25-27; the Flint Summer Fair at the Cultural Center will be held June 26-27; the Houghton Lake Summer Festival will open June 26 and run through July 4; and the Interntional Freedom Festival will be held in Hart Plaza in Detroit, June 25-July 4.

BRAMS 124 NORTH LARCH STREET, LANSING, MICHIGAN 48901

May 27, 1981

Senator William A. Sederburg
802 Senate Office Building
Lansing, Michigan 48909

RE: Unnecessary spending by a State Agency:
(Michigan State Highway Department)

Dear Senator:

If you recall in our meeting when you visited our firm several weeks ago our main concern was the Michigan State Highway Departments, Aerial Photography and Mapping Division. As was discussed, we felt that this was an area that our State could eliminate an agency which in our estimation has to be classified as a luxury and not a necessity. Following is an example of what we are talking about.

Project: Central Industrial Park
For the Community & Economic Development Dept.
City of Detroit
Area ±520.00 acres (the old Chrysler Dodge Main Plant Site)

The above mentioned project is one which we performed the following services late last fall and early winter.

1. Acquisition of new aerial photography
2. Acquisition of ground control survey to support topographic mapping of Plant Site.
3. Topographic mapping of area at a scale of 1"=40' showing 1' contours.

Our total project fee for providing the above mentioned services was $19,4[illegible]0.0

It has been brought to our attention that the Michigan State Highway Dept. Aerial Photo & Mapping Division is now in the process of providing the same basic services that we provided for our client, for the Highway Design Department. They are aware of what we have already done covering the area, but have decided to go ahead and do the job over again for their use! The aerial photography was accomplished on or about the 14th of May.

Summarized what it boils down to is this; if the Highway Design Department was to contact us, we could provide them with whatever their mapping needs are from the existing information already available at a fraction of what it will cost them by doing the job inhouse from scratch. Of course this would entail contracting with private industry and verifying our claim, that there is really no justification for them maintaining their own inhouse mapping department.

You may rest assured that we will be monitoring the activities of this State owned mapping firm from now on and keep you advised as to what we in the private business world have to contend with and support through our tax dollars.

Cordially,

Thomas M. Schafer
President

TMS/dlh

cc: Carl Schweitzer, Senate Fiscal Agency
Senator Alvin J. DeGrow
Senator Harry A. DeMaso
Senator David S. Holmes
Senator James DeSana
Senator Jerome T. Hart
Senator Mitch Irwin
Senator David A. Plawecki
Senator John M. Engler

George Rush, Fiscal Analyst
Representative Edward F. Mahalak
Representative Dominic J. Jacobetti
Representative Joyce Symons
Representative Frank V. Wierzbicki
Representative Donald Van Singel
Representative Robert A. Welborn

2050

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President
DAVID SCHREUR
Vice President
ROGER C. CRIMMINS
U.P. Vice President
MICHAEL F. DONOHOE
Secretary-Treasurer

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Director Employer Relations
J. E. OSMER
Director Government Relations
C. O. RONK
Director Communications
and Education

MICHIGAN ROAD BUILDERS ASSOCIATION, INC.

February 19, 1987

Ms. Marty Andrews
Business Associated for a Stronger Economy
P. O. Box 20171
Lansing, Michigan 48901

Dear Marty,

At the February BASE meeting, I distributed copies of the "Progress Report on Privatization Efforts in State Government" compiled by the Michigan Department of Management and Budget (DMB). At that meeting there was some talk about having BASE contact DMB regarding other areas that could be surveyed for privatization from the various state departments.

The Michigan Road Builders Association has reviewed this report and would like to make some suggestions of areas in which the Michigan Department of Transportation could research having more work done by the private sector. Below is a list of the areas we would like to see evaluated:

** Within the area of highway and bridge maintenance division, we recommend that more pavement, bridge deck and guard rail repair and replacement be examined.

** We would also like to see winter ice and snow removal, pavement patching, sealing and joint repair, shoulder grading and replacement, roadside mowing, drainage and culvert maintenance, rest area maintenance, signing and pavement marking given more consideration for contracting out.

** In the area of building maintenance, real property management section, we recommend that more building maintenance projects be examined for contracting.

** For capital outlay projects, real property management section, we would like to see the construction remodeling and additions to existing buildings as well as other projects related to the improvement of buildings be contracted out including long-term, 12-month minimum (maintenance) contracts.

Sincerely,

Cheryl Ronk

Cheryl O. Ronk
Director, Communications and Education

GOVT. COMP.

DEPARTMENT OF DEFENSE • UNITED STATES OF AMERICA

DEPARTMENT OF THE ARMY
HEADQUARTERS UNITED STATES ARMY TRAINING AND DOCTRINE COMMAND
FORT MONROE, VIRGINIA 23651

ATLG-P

15 APR 1975

Mr. Thomas H. Brinkman
Executive Secretary
Marking Device Association
708 Church Street
Evanston, IL 60201

See
3/28
"Bi"

Dear Mr. Brinkman:

This is in reply to your 18 March 1975 letter to Mr. Scott of United States Army Materiel Command, which was forwarded to this headquarters on 25 March 1975.

Rubber stamps are being fabricated at Fort Sill, Oklahoma for use by the United States Army, since they can be fabricated in-house at a lower cost than if they were procured from a commercial source.

The United States Army fabricates many items in-house; and, cost is one of the factors considered in making the decision whether or not to fabricate an item in-house. These rubber stamps are not sold in competition with members of your association nor is there any intrusion into the private business sector of the economy.

Sincerely yours,

Michael A. Randall

MICHAEL A. RANDALL
MAJ., AGC
Asst AG

CF:
Cdr, US Army Materiel Command
5001 Eisenhower Avenue
ATTN: AMCRP-SO/Mr. Scott
Alexandria, VA 22333

n Name Plate Corp.

SETON

592 BOULEVARD
NEW HAVEN, CONN. 06519
TELEPHONE: (203) 772-2520

March 13, 1975

Benjamin F. Bailar, Postmaster General
UNITED STATES POSTAL SERVICE
Washington, D. C. 20024

Dear Mr. Bailar:

As a small businessman, I write to you to strongly protest the sale of hand stamps and stationery items by the U. S. Postal Service in their so-called "boutiques".

This is really a scandal, Mr. Bailar. It is unbelievable that the Federal Government will not only compete with legitimate United States businessmen/taxpayers...but it appears as though insult has been added to injury, for I understand that at least some of the rubber stamps being sold in the U. S. Post Offices are actually being produced in Japan!

My company does not make rubber stamps, Mr. Bailar, but if we did, I would surely be deeply perturbed.

It would be most reassuring if you can advise me that you will do everything within your power to stamp out this blatant intrusion by the Government...which trods on the constitutional rights of small businessmen.

Yours most sincerely,

rl
Blind copy: Mr. Thomas H. Brinkmann

GOVT COMP.

March 25, 1975

Benjamin F. Bailar, Postmaster General
United States Postal Service
Washington, DC 20024

Dear Mr. Bailar:

We sincerely hope that in your role as Postmaster General you will be sensitive to the problem of Post Offices competing with taxpayers in the sale of retail merchandise.

As the trade association representing manufacturers of rubber stamps, we will admit that the actual financial impact of the sale of such products by Post Offices does not have overwhelming financial impact on our industry. However, the principle of the thing concerns us very much.

We of course were encouraged by the recommendations made by Representative Hanley's Postal Services Subcommittee that these retail sales be discontinued. We sincerely hope that you will assume that same position.

Very truly yours,

Thomas H. Brinkmann
thb;hd

NOPA GOVERNMENT ALERT

Published by the NATIONAL OFFICE PRODUCTS ASSOCIATION Suite 1200 1500 Wilson Blvd. Arlington, Virginia 22209 | 703-525-2868

GOVT. COMP.

TO: NOPA MEMBERS

FROM: BRUCE MCLELLAN, DIRECTOR OF GOVERNMENT RELATIONS

DATE: MAY 9, 1975

Postmaster General Confirms the End of Postal Boutiques and Other Retailing Activities

U. S. Postmaster General Benjamin F. Bailar has advised Congressman James Hanley (D-NY) Chairman of the House Postal Service Subcommittee that U.S. Postal Service sales of office products will end.

Bailar stated in a letter to Hanley, dated May 7, 1975:

> "Having considered the arguments for and against this program I have concluded that, in view of the Subcommittee's consensus, those aspects of the program to which objection is raised should be eliminated. In keeping with the report's recommendation, this will be done in an orderly manner. Existing inventories will be sold out, and in the case of photocopy services, contracts will be allowed to expire".

The report to which Bailar refers is the January 3, 1975 Report of the Subcommittee on Postal Service of the House Committee on Post Office and Civil Service. The report, unanimously approved by the Members of the Committee contained three basic directives as follows:

1) Postal related items be removed from post offices once current inventory is depleted.
2) Cease offering photocopying services by cancelling all short-term contracts, not renewing any long-term contracts and not entering into any new contracts with any companies offering photocopying machines.
3) Permit the sale of a very limited number of items in extremely remote areas where no private business serves the area.

The phase-out of the program begins immediately.

The Postmaster General's announcement caps a long, but at last, successful campaign by NOPA to eliminate Postal Service competition with the industry. The campaign took your Association through three Congressional hearings by two Committees of Congress, a U. S. General Accounting Office Investigation, and numerous personal meetings. It involved literally hundreds of letters and personal contacts by NOPA dealers, manufacturers, wholesalers and sales and marketing members.

In accepting the Postmaster General's announcement. Hanley commended the decision as being "in step with the theory that no government agency should compete unfairly or unnecessarily with private enterprise".

We certainly agree and we commend Chairman Hanley and Congressman William Hungate of the House Small Business Committee for insisting that the theory be put into practice.

Roles of public library exclude video rentals

Point of View

By Doug Cruce

The author of this commentary is a state senator (R-Troy), representing the 18th District. He is a member of the Appropriations Committee and Government Operations Committee.

There has been significant interest recently in two bills I introduced in the Michigan Senate which deal with library rentals of video tapes. As many readers know, I do not feel that a publicly funded government institution should work in areas of direct competition with the pre-existing free enterprise system.

Based on this philosophy, I have problems when a library, which according to current law "shall be forever free to the use of the inhabitants," charges for materials. This applies especially to library rentals of home video entertainment tapes.

The idea that libraries should be free to residents is the most important aspect of our library system. In opposing my bill, libraries will argue that videos are expensive and costly to maintain. This is true. But this very same argument was used about books when public libraries were established in this state over 100 years ago. To make libraries accessible to all the people, our tax dollars support this institution.

Encyclopedias are very expensive books, but libraries don't charge a rental fee for the use of these books. No one would stand for a library charging for the loan of an encyclopedia. The cornerstone of the library system is the fact that they are available to everyone in the community, not just those who can afford the services. Are video tapes any different?

True, some libraries have responsible policies regarding video tapes, involving a well balanced tape selection dominated by educational, instructional and classical tapes that are not normally found anywhere else. In such cases, the library collection truly serves a public need that cannot be met by the private sector.

Unfortunately, most libraries do not specialize in educational films, as they have been leading us to believe. A quick check of the titles will reveal to the public what we have discovered in our research on these bills; the majority of library rental films are feature films.

Many libraries are using profit as the motive in providing video tape services, their decisions based on a profit motive instead of public need. This has drawn libraries into direct competition with video stores. Many have concentrated so heavily on popular videos that their collection is virtually indistinguishable from an average video store collection. We should not be spending our property tax dollars on nothing more than a glorified discount video store.

This points to another flaw in the current system of providing video tapes at public expense: interference with the free enterprise system. By directly competing with local video stores, we are discouraging local enterprises which pay taxes and provide jobs in our community. And we all benefit from these contributions.

Many libraries have argued that, carried to their logical conclusion, my bills would eventually prevent other government services such as public parks and other library services, since the private sector also offers these services for sale.

The test for government involvement in a commercial enterprise should be, "Is the service or product available in the private sector at a price that is fair?" In the case of video rentals, the answer is "yes," and consequently the government has no business using taxpayer money to go into the video business.

With other library services, however, like loaning books, there is no business that offers this service; therefore it is a legitimate government function.

The intent of my legislation is to insure that the decision by a library to purchase a video tape meets the same criteria that any book or magazine must meet in order to become part of a library collection. I believe most libraries will continue to carry video tapes, especially those not normally found in commercial video stores.

Ben Franklin, as the founder of the first free public library, felt that every citizen deserves access to everything books have to offer. While the scope of libraries has expanded, the ideals remain the same. Had he used the same logic in loaning books that our current libraries are using to rent video tapes, the first public library may also have been the last.

Point of View is a forum of public opinion. If you have expertise and opinions about a matter of public interest and would like to write an essay, contact Bob Stuart, Editorial Page Editor.

UNIVERSITY BIDDING UPDATE

Unfair competition of colleges and universities with the private sector has been one the primary areas of concern and discussion for B.A.S.E. members. Several examples of unfair university competition have involved the policies and procedures of the Department of Management and Budget which allow colleges and universities to submit bids and compete with small business persons for state contracts. The university is often awarded the bid since they do not have to include their overhead costs as part of their proposal. The business person does not have this advantage.

In response to pressures by small businesses affected by the state's bidding procedures and concerns raised by B.A.S.E., the Department of Management and Budget has issued a new policy which is intended to limit the bidding process for colleges and universities to make the awarding of contracts fairer for small business. This administrative policy directs the Department to solicit bids from colleges and universities only if the service can be provided solely by an educational institution. If the service is provided in the private sector, bids are solicited only from the private sector. The written policy states:

> "Educational or governmental services are defined as those that can only be acquired through educational or other governmental entities because of the unavailability of such services from the private sector. These services would be limited to programmatically-related research, scientific, educational or governmental programs which are directly linked to the State's service needs." - Administrative Manual, Department of Management and Budget, 8-2-1.

Although this policy change has not remedied every instance of college and university bidding, unfair competition has been greatly reduced. Thanks to the Department of Management and Budget for trying to address our concerns and thanks to all small business persons whose persistence and patience helped bring about this change!!

- Department and Agency: A "State agency" means a department, board, commission, office, agency, authority, or other unit of State government. State agency does not include an institution of higher education or a community college.

- Educational or Governmental Services: Educational or governmental services are defined as those services that can only be acquired through educational or other governmental entities because of the unavailability of such services from the private sector. These services would be limited to programmatically-related research or scientific, educational or governmental programs which are directly linked to the State's service needs.

- General Labor Services: General services are defined as those types of services that are predominantly performed by non-professional services firms or individuals who are responsible for completing tasks defined in the RFQ or RFP in accordance with specifications and methods.

- Grants: A grant(s) is an appropriation, either by line item or boilerplate reference, or other expression of legislative intent which is exempt. The Office of Purchasing, however, is responsible for procuring supplies, materials, services, and equipment funded by grants to State departments and agencies.

- Liquidated Damages: In those cases where the State can quantify financial losses resulting from non-performance, a liquidated damages clause may be incorporated into a contract spelling out the manner by which the State and the contractor agree to provide financial reimbursement.

- Joint Evaluation Committee: A joint evaluation committee is an advisory body which evaluates proposals and makes a recommendation for award to the State Purchasing Director.

- Minority Business Enterprise/Women Business Enterprise (MBE/WBE): Public Act 428 of 1980 defines a MBE/WBE as "a business enterprise of which more than 50% of the voting shares or interest in the business is owned, controlled, and operated by individuals who are members of a minority and with respect to which more than 50% of the net profit or loss attributable to the business accrues to the shareholders who are members of a minority."

- Multi-Phased Project: Any information system consulting project which has a total estimated completion cost over $1,000,000 will require individual solicitations dividing the study phase from the design and implementation phases.

PAGE 15
FRIDAY, AUGUST 12, 1983

Colleges' Bids For Work Rile Private Labs

By MICHAEL W. MILLER
Staff Reporter of THE WALL STREET JOURNAL

Charles Evans, who used to be a chemistry professor, owns a laboratory in San Mateo, Calif., that does technical analysis for private companies. He charges $275 an hour for work performed on a big, expensive microscope, called a secondary ion mass spectrometer.

At the University of North Carolina, Richard Linton operates a similar instrument. Mostly, the machine helps in research and teaching, but 5% of its time is used to do work for clients such as General Electric Co., International Business Machines Corp. and Union Carbide Corp. The university charges $25 an hour less than Mr. Evans does.

Like many private lab owners, Mr. Evans is angry that universities aren't sticking to research and teaching but are increasingly doing short-term, applied work. The private labs say universities are competing unfairly because they enjoy tax advantages and public subsidies that allow them to undercut prices at private companies by as much as half.

Mr. Evans, who left a faculty job at the University of Illinois in 1978 to start his company, says his lab, which had revenue of $1.2 million last year, loses more than $100,000 a year in business to universities. He estimates that overall, universities take several million dollars worth of work each year from private labs.

Competition from nonprofit institutions is "the most serious challenge to this industry at present," says Earl H. Hess, president-elect of the American Council of Independent Laboratories, which represents 267 companies that do research and analysis for government and industry.

Taking Competitors to Court

To lobby in Washington, the council has helped organize a coalition with other trade groups whose industries are concerned about competition from nonprofit groups. Some private companies are taking nonprofit competitors to court, but much of the effort involves attempts to persuade university administrators to stop commercial enterprises.

It's impossible to gauge how much private work universities do, partly because the professors sometimes lack official sanction.

Last year, for instance, a chemistry professor at Michigan Technological University circulated a six-page brochure advertising the services of some of its laboratory facilities. The booklet promised "precise, accurate analysis" of water, hazardous waste, exhaust emissions and other chemicals.

Among the brochure's recipients was a Pennsylvania scientist named Charles A. Garber, president of a private lab called Structure Probe. He wasn't pleased by what he read. In a letter to the university's president, he complained that the chemist was "running a commercial business out of the university . . . in direct competition with taxpaying, for-profit laboratories both in and outside of Michigan."

In January, the university wrote a short, sheepish response saying administrators called off the lab's operation as soon as they found out about the circular. The university said no commercial work had been done, as far as it knew, and that its chemistry department "is not engaged in the commercial analytical chemistry business."

Stopping Professors

Mr. Garber, the Pennsylvania scientist, is one of the most persistent of the lab owners who complain to universities. Last year, after receiving letters from him, administrators at Johns Hopkins University and the University of California stopped professors from offering commercial services. Mr. Garber says some labs are being misused, and stopping the business only requires drawing administrators' attention to it.

But some lab work is done with approval of universities, and they defend their right to do the work. The University of North Carolina's Mr. Linton says he needs the fees from industry to keep his secondary ion mass spectrometer in operation. It was bought with a $700,000 National Science Foundation grant, but the award makes no provision for operating expenses, which might be as much as $100,000 annually.

"The reason we do this work at all," Mr. Linton says, "is that without the commitment of a sustained, guaranteeable amount of money from funding agencies, we need a stopgap measure to assure our instrument has at least a minimal level of support."

At the State University of New York at Albany, the physics department regularly performs a microscope procedure called Rutherford backscattering, which Mr. Evans's lab in California also offers. The department serves clients like General Electric, Corning Glass Works and IBM. It charges $200 an hour, which is $75 less than the rate at the Evans lab.

The department's chairman, Walter M. Gibson, says he isn't interested in competing with Mr. Evans. But he says: "The day he hangs up a shingle, we can't suddenly turn away people we've been working with for some time."

He also takes some credit for making the service commercially marketable. "It's through trying out things on facilities such as ours that people have become aware of the power of the techniques, and are therefore willing to turn to someone on a commercial basis for regular use," Mr. Gibson says.

Labs have been reluctant to take their

Please Turn to Page 29, Column 4

Continued From Page 15

nonprofit competitors to court since Mr. Garber lost an appeal in 1979 of a $1 million suit he filed against the Franklin Institute, a Philadelphia research organization. Mr. Garber claimed the institute violated antitrust laws and statutes on nonprofit activities by selling the services of its scanning electron microscope at about half the price charged by his firm.

Other industries have pursued litigation, with varying success. In February, the Supreme Court gave a group of pharmacies the right to sue the University of Alabama over prices at its hospital drugstore. The University of New Hampshire agreed in January to give its required reading lists to a local bookstore after the store sued. But in April, two travel agencies lost a suit against the University of Minnesota in which they sought damages due to the operation of a student-run travel service.

Laboratories have been more successful in their Washington lobbying than in their litigation.

The National Science Foundation, after heavy lobbying by the private labs, made a new policy saying university equipment it pays for shouldn't be used to compete directly with private companies.

Marty: The Printing business is not alon
Vern

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PROFESSOR IN PINSTRIPES

DR. SHEILA RONIS RUNS BUSINESS FOR UNIVERSITY —

by KATHLEEN GARDINER

A new kind of enterprise has been born at the Renaissance Campus of the University of Detroit. It's called the Institute of Business and Community Services and is an entrepreneurial program of the school.

Created to help the community, corporations and the state of Michigan, the Institute is also designed to make money for the university.

Institute Director, Dr. Sheila Ronis, says, "What we do at the Institute is help business meet its needs and solve its problems. This new, evolving program began in June 1985 offering a variety of services. Today, 90 percent of the Institute's work is brokering consultants and managing consulting projects.

"We assist companies by finding the appropriate expertise and we have a network of experts throughout the country. We have a commitment to the state of Michigan to use Michigan expertise first. We have used local talent almost exclusively."

The Institute subcontracts much of its work to other firms. That works to its advantage, says Ronis, because other consulting firms must use their own staff. As a subcontractor, Ronis can use outside talent to help her clients.

"As the Institute's only full-time person on staff," says Ronis, "I have total latitude to subcontract work to whomever I want: faculty experts, local consultants and retired executives."

Ronis is on the faculty of the Management Department of the business school and teaches strategic management and business policy in the master of business administration program. She is also director of the Renaissance Campus Business Program, which includes the Institute and the evening business program.

"I founded the Institute with the vision of Dr. Gregory W. Ulferts, Dean of the College of Business and Administration at the university. I was an adjunct professor at the university and worked as a strategic planner at Ameritech Publishing.

"I told Dr. Ulferts I wanted to start a management consulting firm and, in turn, he asked me to start one for the university."

Ronis says her work has grown quickly, both in the number of clients and in the amount of revenue generated for the university.

"Besides business planning," says Ronis, "we also provide executive management development through our consulting efforts.

continued on page 40

PROFESSOR

continued from page 26

We find out what the problem is. If training is the solution, we will develop the training. I've had presidents of corporations in my seminars," says Ronis.

Ronis is equally comfortable in high tech as in organizational areas. Her undergraduate degree at Ohio State University was in physics and math; her graduate and doctoral work was on organizational behavior.

Does the Institute help only large businesses?

"No. While our services are not free, our contracts range from six figures to less than a thousand dollars. Almost any business can afford us."

As a working mother and wife, Ronis has some advice on business for women.

"Be cautious, but optimistic. Women can make it in business. I think I represent someone who was able to do it. If you have entrepreneurial skills and seek out the right expertise, you can accomplish personal and professional objectives... even in a man's world. Fifteen years ago, as a woman, I wouldn't have been successful in this venture. But the world is changing."

Kathleen Gardiner is a writer from Royal Oak who has written previously for The Michigan Woman.

COMMITTEE OF 200

continued from page 25

Committee of 200 member Theresa Staal applied her teaching skills to a new business enterprise, which eventually made her chairwoman of Newman Communications in Grand Rapids. The audio-visual hardware dealer and videotape production firm was recently sold to Marvin Schultz, owner of City Animation, an audio-visual company based in Troy.

"Newman Communications will now become a big company, but I am no longer involved in any capacity," Staal says. "I don't know what I'll be doing, but I doubt that I'll be sitting at home."

That would indeed be out of character for Staal, who was once a high school teacher. She left that career to become a consultant at a learning center. In 1969, she joined Newman, becoming the first woman in the country to be an educational consultant for an audio-visual company.

"I bought some stock in the company," Staal says," and eventually was elected to the board of directors and then my job mushroomed. When one of the presidents retired, I bought more stock and became the company's major stockholder and the chairman of the board."

Staal, 58, lives in Grandville and is single.

"There are some women older than I am and some younger ones in the organization," Staal says. "What amazes me is that some of these women are relatively young to have achieved a top position. And we're getting more young ones, which is great."

What does Staal find is the network's greatest benefit?

"One of the major values for me is being able to meet twice a year with other women who are also owners of companies, and who are having the same types of problems I have," Staal says. "I've made some very, very close friends all over the country. Being able to talk intimately and freely with other women business owners is wonderful.

It's sometimes difficult to find someone who can talk freely to, and who understands your position and your problems. I think we do talk more freely among women. We're not competing with each other, as we often are with men. The men have their groups, and they talk more freely amongst themselves than in a mixed group. I think the same is true with women."

Cynthia Hoogasian is an award winning journalist and associate editor of Florist Magazine in Southfield.

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TOLL FREE: CALL 800-292-1044 (MICHIGAN ONLY)

May 23, 1983

Honorable William Sederburg
Michigan State Senate
State Capitol Building
Lansing, Michigan 48909

Dear Senator Sederburg:

This morning, Ruth Tanner of Michigan State University called our office and talked to our Executive Director, Lynn L. Briggs. She was attempting to receive from Mr. Briggs a list of all associations of the state in order to sell from MSU audio/visual products and services, printing, signs, etc. When he asked Ms. Tanner if she thought this was unfair competition with commercial companies who are fighting an uphill battle to stay alive in Michigan, she answered, "No, I don't think so." Her response concluded that she needed to sell the services of her department to generate revenue to keep the department open.

I sympathize with people who face the loss of their job, but if someone is to lose their job, wouldn't it be better if the loss were from the public sector (tax dollars spent) versus the private sector (tax dollars generated)? This activity is exactly what must be stopped so that the budget of the state government can be reduced and revenue can be generated to keep the important functions of state government and public institutions alive.

It is apparent from the conversation with Ms. Tanner (as related to me by Mr. Briggs) that the people in the public sector who are engaged in these activities that are in unfair competition with the private sector, do not realize the harmful side effects, nor do they figure the total costs.

Having legislation that will require all departments of state government and all public-supported institutions, such as universities, mental hospitals, etc., factor in (through some formula) the Single Business Tax, property taxes, wages, marketing, utilities, etc., will make them realize that they cannot compete fairly and should, therefore, get out of business. Competition against the private sector is not a function of public "service" and should not be supported by taxes.

Washington, D.C.

I would appreciate very much your every effort in helping to assure that the necessary legislation is passed to put these activities back into the proper perspective so that the public sector and private sector can complement each other for a healthy and vigorous economy.

Best regards,

MICHIGAN PLUMBING & MECHANICAL
CONTRACTORS ASSOCIATION

Michael H West

Michael H. West
Assistant Executive Director

MHW:kd
CC: Martha Andrews, Mid-Michigan Stamps and Signs
Governor James Blanchard
Representative Thomas Mathieu
Representative Paul Hillegonds
Phil Jordan, Director/Mgmt and Budget

MICHIGAN STATE UNIVERSITY VERSUS THE PRIVATE SECTOR

Examples:

Ruth Tanner from the MSU Instructional Media Department phoned the Michigan Plumber's Association requesting a list of their member companies in order to sell services and goods to companies that private sector businesses normally provide for.

Ruth Tanner Called Mid-Michigan Stamps & Signs several times requesting pricing information in order to sell their goods at lower prices than Mid-Michigan when competing on quotations.

Ruth Tanner called Mid-Michigan Stamps & Signs requesting a loan of a die in order to manufacture name tags for the Dept. of Labor, stating that they had won the bid for this particular job which they had quoted. She also requested price information signs that were originally manufactured at Mid-Michigan Stamps & Signs, as she did not seem to know how to price her own signs. She was noticeably irritated when told that Mid-Michigan would not reveal their prices.

An unidentified person from MSU, after taking up about 20 minutes of a sales person's time requesting information on the cost of 2,000 key tags from Mid-Michigan Stamps & Signs, stated after he was told the price that he was from the Instructional Media Dept. at MSU.

Still another example was when a student at MSU called Mid-Michigan Stamps & Signs wanting to know what materials to use on a certain type of sign and how to price it, adding that he would not get a grade if he did not design a sign and sell it as well.

Mid-Michigan Stamps & Signs is obligated, like any other business in the State of Michigan, to pay taxes in support of MSU as well as governmantal agencies; the very same agencies who, by practicing unfair competition, force small businesses to lay off employees. These are the very employees who generate the tax base to support government. This creates higher taxes for all citizens of Michigan when government supported agencies buy equipment with tax-funded monies. Waste from lack of experience, overhead costs & benefits, and the loss of taxes not being generated put a hardship on our state economy, and lead to lay-offs of many people who really need the Free Enterprise system to make a living.

Marty Andrews

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JAMES J. DUDERSTADT
Provost and
Vice-President for Academic Affairs

December 19, 1986

To: University of Michigan Students, Faculty, and Staff

I am pleased to announce that the University of Michigan and Apple Computer have joined forces to make it significantly easier for everyone on campus to own a personal computer. The opportunity comes in the form of a special event called Computer Weekend, two days during which all eligible full-time students, faculty, and staff will be able to purchase an Apple Macintosh personal computer for as much as 25 percent off the normal University price or 52 percent off the full retail list price.

Computer Weekend is scheduled for February 7 and 8 at the North Campus Commons. Advance orders will be accepted beginning January 5.

Computer Weekend is an extension of the University's substantial, continuing commitment to the role of computers in higher education. Recent advances in information technology at the University include the acquisition of a new mainframe computer at the Computing Center, expansion of our computer network to permit connection of all rooms in residence halls and offices on campus, and a significant increase in the number of computer workstations available for student use at public sites. In addition, thousands of people each semester take advantage of free computer classes offered at the Microcomputer Education Center. When you purchase your own personal computer, you can benefit even more from these services.

The freedom and convenience of ownership are obvious. At even the most basic level, a personal computer is a tremendous tool that can help you:

- collect and organize information
- outline your thoughts on a topic
- speed the editing and revision process
- produce clean drafts and final copy

And if you connect your microcomputer to the University's campus network, you can:

- send messages and share text with colleagues or classmates using electronic mail
- access library reference systems
- participate in computer-based conferences and discussion groups
- utilize larger computing systems for advanced word processing, database management, and a variety of instructional and research applications

The enclosed materials outline the advantages of personal computer ownership, describe the Macintosh products and prices being offered, and explain procedures for placing your order in advance. In addition to the Macintosh sale by the University, values on software and accessories will be offered by several Apple dealers: *ComputerLand of Ann Arbor*, *Inacomp Computer Center - Ann Arbor*, and *The Learning Center, Ltd.* You can take advantage of the extra-low Macintosh pricing and these dealer specials only during Computer Weekend.

Computer Weekend is an exceptional opportunity offered specifically for your benefit. I hope you will carefully consider participating.

Sincerely,

Jim Duderstadt

James J. Duderstadt

The Benefits of Owning an Apple Macintosh

What will it do?

You may already have a good sense of what a personal computer will do for you; many thousands of people at the University already own one and many more have used one. Nonetheless, a quick review of a few important benefits may prove helpful.

Most people recognize the advantages of computers for writing and producing an attractively printed final document. Less widely appreciated is the value of a computer in gathering bibliographic information from a library, collecting and organizing notes, outlining your thoughts, and simplifying the editing and rewriting of text. Some computers, including the Macintosh, can handle a variety of foreign languages, as well as various mathematical and other specialized symbols.

When you add a network connection to your personal computer, you open up important opportunities for communicating with other people. The University community increasingly uses electronic mail to send messages to friends and colleagues, and there are many computer-based conferences or "discussion groups" which people may join to explore a wide range of topics. A network connection allows access to shared resources, such as laser printers and larger computers. The University's central computers offer a wide variety of software and information, readily accessible with a network connection.

With the appropriate software, personal computers provide various methods for doing calculations and for constructing and exploring mathematical models. The Macintosh can be a very creative tool for visualizations, ranging from simple sketches for a science lab, to a graph for a statistical summary, to a complex artistic rendering. The Macintosh can be used to explore many facets of sound and music. In these and many other ways, a personal computer such as the Macintosh can be used to make learning more productive and enrich the forms of expression and communication available to the individual.

Is the Macintosh best?

You may be wondering whether the Apple Macintosh is your best choice. The enclosed materials provide further information, and a supplementary packet is available at several sites on campus. In brief, the Macintosh is an excellent personal computer that has found wide acceptance at the University: it is powerful, yet easy to learn and use; a wide variety of good software is available; it offers a richness of expression with many character sets and symbols, graphics, and sound; it has proven reliable; it takes little desk space; and it operates quietly. If you prefer a different choice, computers from other vendors are available through the regular University discount sales program.

Is this the time to buy?

There is always a question with computer purchases about the right time for buying. We believe that if you want a Macintosh, this is an exceptionally good opportunity. But if you want the same general virtues the Macintosh has, yet want more computing power and you are willing to spend significantly more money, then this may not be a good buying time; we expect that by this Fall there will be several vendors offering advanced workstations fitting that general description. However, for most prospective purchasers, Computer Weekend offers a very attractive time to buy.

Will this help students get more from their fees?

It may be helpful for you to understand the relationship between this effort at encouraging personal computer ownership and the Information Technology Access Fee paid by all students. The fee covers part of the costs of increasing the level of services available to students, including the expansion of public sites, greater access to central computing resources, and facilitating the use of personal computers. If you are a student, personal ownership of a computer will give you the utmost leverage from the fee.

When you own a computer you can use it in your private study space, whenever needed, at your pace, in your style. You can make it a larger and larger part of your learning and your leisure activities. You can use it for taking notes while studying, outlining and writing text, for modeling and sketching ideas, all with a readiness and freedom that could be approached only by spending many hours a week at the public sites. Furthermore, regardless of how many public sites are built, they are still likely to be crowded with people waiting in queues during the end of each term. Thus, while it may seem as though the basic consideration is a simple matter of how often you "really" need such a computer, experience suggests that you will often get much more use from your own computer than you can from one in a public site.

At the same time, you will still benefit from access to the public sites to augment your personal system. Public sites provide a place to do your computing when on campus and when working with others in a group. They offer access to resources beyond what you may have on your own system: connection to the campus network, high-quality printing, use of other software packages or brands of personal computers, and work on more expensive high-performance workstations. The public sites will help you get the maximum from your own system and the personal experience gained from its use.

What resources does the University make available?

Many benefits of personal computer ownership are built upon the resource foundation provided by the University as a result of its commitment to leadership in the use of information technology. The University has made very substantial investments in the past several years, placing us at the forefront of technological advances. For example:

- We have acquired an IBM 3090-400 as the mainframe at our Computing Center to support substantially increased access, including the growing number of request accounts for students, faculty, and staff on the Michigan Terminal System (MTS). This system is central to our messaging and conferencing resources and to much of the instructional and research computing, and it is accessible from any personal computer using the campus network, UMnet.

- We are continuing the development of UMnet to connect every Residence Hall room and campus office. For many people, a direct network connection is conveniently available on campus, while for others there is dial-up access from homes and apartments. There is also expanded capability for communicating to and from other places in the state and nation through the MERIT network.

- There has been a significant increase in the number of computer workstations in public sites for student use, now totalling about 1300, about 250 of which are in Engineering and 200 in Business Administration. At least 500 more will be added in the future. The public sites provide direct access to several different types of personal computers and a variety of software, and offer options for getting printed output. Every workstation is connected to UMnet for access to other computers, including the IBM 3090.

- We have initiated a major program for purchasing a personal computer and learning about its use at the Microcomputer Education Center. In addition to offering assistance with specific questions and providing informative publications, there are many no-cost courses offered which range from introductions to the use of a computer to more advanced coverage of specific software applications.

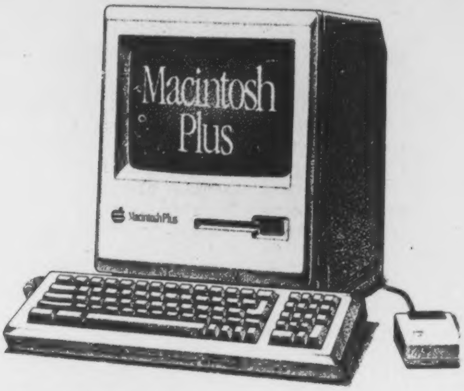
By making it easy to own a personal computer, Computer Weekend makes it possible for you to take greater advantage of these and other computing resources being offered by the University. We encourage you to participate.

Price comparisons

The table below compares the prices of the four Macintosh configurations being offered (see the attached order form for details of the configurations) with the prices under the normal University discount program and the full retail list price.

	Computer Weekend	Normal U-M Price	Full Retail List
#1 (MacPlus, 800k disk)	$1420	$1870	$2993
#2 (MacPlus, 800k disk, printer)	$1850	$2325	$3618
#3 (MacPlus, 20 Meg disk)	$2120	$2555	$3973
#4 (MacPlus, 20 Meg disk, printer)	$2550	$3010	$4598

Product Descriptions

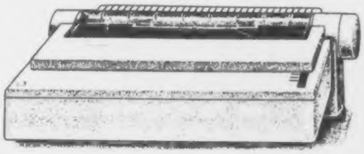


Macintosh™ Plus Personal Computer

The High Performance Macintosh

The Macintosh Plus is the most powerful Macintosh made by Apple®. It features the standard easy-to-use Macintosh operating system allowing you to concentrate on your application rather than learning to use the computer. The high resolution screen and advanced graphics capability provide the advantage of on-screen integration of text and graphics. The system offers one megabyte of internal memory to handle the most memory-intensive applications and files, such as lengthy word-processing documents, large spreadsheets, and extensive databases. The Macintosh Plus also has a built-in 800 kilobyte disk drive for fast loading of applications and data and a high-speed peripheral connector (Small Computer System Interface or SCSI) that can handle up to seven daisy-chained devices. This allows you to add more peripherals to expand your Macintosh system with future accessories. The keyboard offers a numeric keypad and cursor keys for easy data entry. All these features add up to a powerful system when combined with over one thousand commercial and university-developed software packages now available for the Macintosh.

With your order you will receive: Macintosh Plus personal computer with built-in 9 inch monitor and 800-kilobyte disk drive, mouse, detachable keyboard, Owner's guide, system tools disk and backup, software sampler disk, 90 day limited warranty statement.

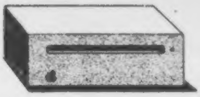


Apple ImageWriter //

Sophisticated Text and Graphics Output for your Apple Personal Computer

The Apple ImageWriter // printer enhances the quality of all printed communications. It generates high-quality text and graphics in black or - with appropriate software - in color. You can take advantage of the printer's speed to print up to 2 1/2 pages per minute (250 characters per second), or choose the "near letter quality" mode for a professional look. It handles cut-sheet or continuous paper, including labels, and it can produce multiple copies. Later, you may wish to add the ImageWriter // SheetFeeder for effortless cut-sheet printing or an AppleTalk card, which enables you to share the printer over the AppleTalk Personal Network. Use the ImageWriter // for any application - from term papers and mathematical reports to accounting summaries and artwork.

With your order you will receive: ImageWriter // printer, Power cord, Ribbon cassette (black), User's guide, 90 day limited warranty statement, Macintosh Plus Peripheral-8 cable

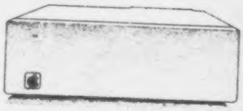


Macintosh 800K External Drive

High-Density Data Storage for your Macintosh Personal Computer

The Macintosh 800K External Drive gives the Macintosh more flexibility, convenience and power. The drive accepts double sided 3 1/2 inch diskes, which can store 800 kilobytes of data each - about 400 typewritten pages of text. Store several application programs on one disk; keep your most important files in one place for easy access without disk swapping. The Macintosh 800K External Drive is a simple addition to your Macintosh that can multiply its power.

With your order you will receive: Macintosh 800K External Drive, Owner's manual, 90 day limited warranty statement.



Apple Hard Disk 20SC

Personal Mass Storage for Your Apple Computer

A complete, self-contained mass-storage system, the Apple Hard Disk 20SC provides 20 megabytes of data capacity - up to 10,000 pages of text: this is equivalent to twenty-five 800-kilobyte 3.5-inch disks. It is ideal for high-performance business, professional, and administrative education applications where mass storage, speed, and flexibility are required. The Apple Hard Disk 20SC lets you keep numerous application programs - as well as all your data files - in one convenient location. In addition, data retrieval and storage are much faster than with a floppy-disk drive. The disk incorporates the Small Computer System Interface (SCSI) standard, which provides faster transfer of information between peripherals and your computer than traditional disk interfaces. Since several SCSI-compatible peripherals can be "daisy-chained" from one port on the computer, you can expand your system with additional hard disks, tape backup systems, or other SCSI devices. The Apple Hard Disk 20SC uses reliable Winchester hard-disk technology.

With your order you will receive: Apple Hard Disk 20SC w/SCSI System Cable and SCSI Cable Terminator, Owner's guide, Installation disk, Power cord, 90 day limited warranty statement

Microsoft® Word 3.0

Powerful document processor software for the Macintosh

Microsoft defines its newest product, Microsoft Word Version 3.0 for Apple Macintosh, as a document processor. More advanced than a word processor, a document processor takes an integrated approach to the task of producing printed materials. Microsoft Word 3.0 includes easy-to-use features that take a writer from the creation of text through editing, formatting, final preparation, and printing. The product provides the ability to profile a document in outline form, create style sheets with most-used formats, preview pages to review layout of headers and footnotes, and use optional short menus of commands so that novice users can become productive in minutes. In addition, it creates integrated text and graphics for desktop publishing functions and supports data interchange with the IBM Document Content Architecture (DCA), a standard among mainframes and minicomputers. Microsoft Word 3.0 also provides an 80,000 word spelling checker and indexing/creation of table of contents capability.

A Special Note: The University does not handle Apple® // computers which are significantly different from the Macintosh. Apple // computers are most popular for K-12 school applications and associated family use. Those interested in the Apple // rather than the Macintosh should consult their local Apple dealer.

Apple and the Apple logo are registered trademarks of Apple Computer, Inc. Macintosh is a registered trademark of Apple Computer, Inc. Microsoft is a registered trademark of the Microsoft Corporation.

Computing Equipment Questionnaire

As a separate matter from the Macintosh offer, we would like to learn a little more about your access to personal computers. **Please check the appropriate boxes below, fold, staple and mail this sheet immediately.** The necessary postage is provided.

I. How often have you used computers during the last year?

☐ generally every day
☐ a few times a week
☐ a few times a month
☐ a few times during the year
☐ not at all

II. Please check one or more boxes below to indicate the type of computers you either own or have immediately available at your job in the University.

☐ No computer
☐ Apple Macintosh
☐ Apple II
☐ Atari
☐ Commodore
☐ IBM PC, XT or AT
☐ NBI
☐ Tandy/Radio Shack
☐ Wang
☐ Zenith
☐ Other ____________

III. Please indicate your interests in a computer purchase:

☐ yes ☐ no I have a computer that meets my needs.
☐ yes ☐ no I will probably take advantage of this Macintosh offer.
☐ yes ☐ no I expect to be acquiring a new computer within the next 12 months.
☐ yes ☐ no I would like a computer but must wait until I can afford one.
☐ yes ☐ no I don't ever expect to be interested in a computer.

IV. Please check all that apply:

☐ yes ☐ no I have been to the Microcomputer Education Center.
☐ yes ☐ no I have used a computer at a Public Access Site, such as the NUBS, or the Undergraduate Library
☐ yes ☐ no I have had training or attended lectures or courses on computer use.

V. And as our last question, please indicate your status.

☐ Undergraduate Student
☐ Graduate Student
☐ Faculty
☐ Staff

The University of Michigan Microcomputer Order Form

Fill out this form completely. Please print clearly or type. See reverse side for further details on ordering.

Name: ______________________ Phone Number: ______________

Mailing Address: ______________________________________
(Street) (City) (State) (Zip)

Student ID Number or Social Security Number: ______________________

(Check only one box)

☐ **Configuration #1:**
Macintosh Plus Computer
800K External Disk Drive
Microsoft WORD **$1,420.00**
with tax $1476.80

☐ **Configuration #2:**
Same as Configuration #1 plus:
ImageWriter II Printer (cable included). **$1,850.00**
with tax $1924.00

☐ **Configuration #3:**
Macintosh Plus Computer
20M SCSI Hard Disk Drive
(cable and terminator included)
Microsoft WORD **$2,120.00**
with tax $2208.80

☐ **Configuration #4:**
Same as Configuration #3 plus:
ImageWriter II Printer (cable included). **$2,550.00**
with tax $2652.00

An optional service contract, known as AppleCare, is available for each of the configurations. Additional information on ordering will be available in information packets at campus locations listed on the reverse side of this form.

This order must be accompanied by a $50.00 deposit or payment in full including tax.
Orders received AFTER Friday, January 16, 1987 have special rules applied.
***** SEE REVERSE SIDE FOR COMPLETE DETAILS OF ORDERING *****

I hereby certify that I am currently (Check only one box):

a full-time student of The University of Michigan, carrying at least
☐ 12 hours as an undergraduate, or
☐ 8 hours as a graduate student, or
☐ 6 hours as a graduate student with 21 accumulated grad credits;

a full-time regular employee of The University of Michigan,
☐ having a 100% appointment (40 hours per week)
AND
that I am eligible to receive all staff benefits.

*****

I further certify that this equipment is for my own personal use and not for resale, lease or disposition for at least two (2) years. Violation of this condition will subject me to payment of liquidated damages to the University of $2000. I may receive questionnaires about the use of my computer from time to time, and I am willing to respond. I have not purchased a microcomputer from the University Program within a two (2) year period prior to the date of this order.

For University Use Only	
A	
B	
C	
D	
E	
F	

Customer Signature: ______________________ **Date:** __________

HOW CAN I ORDER?

Orders are placed by completing the reverse side of this form and returning it with either a $50.00 deposit or payment in full including tax. Payment may be made in the form of a check or money order (no cash) payable to The University of Michigan and mailed to:

The University of Michigan
Photo and Campus Services
542 LSA Building
Ann Arbor, MI 48109-1382

- A cancellation fee of $50.00 will be charged.
- Orders received **ON or BEFORE Friday, January 16, 1987** will guarantee a system at these special prices.
- Orders received **AFTER Friday, January 16, 1987** require an additional **$50.00 late fee**, may not be paid by personal check, and will NOT guarantee a system. In the event that a system is not available, all payments and fees will be refunded in full.

Note that while these are complete computer systems, they do not come with blank disks, paper, or other sundries. Supplies, software, peripheral equipment, and AppleCare maintenance contracts will be available at the distribution site from several local dealers. As of this printing, these dealers include ComputerLand of Ann Arbor, Inacomp Computer Center - Ann Arbor, and The Learning Center, Ltd.

WHO IS ELIGIBLE?

Eligibility is limited to faculty, staff and students of the University of Michigan defined as full-time on the date the order is placed, as determined by the University records:

- Undergraduate students . . . . at least 12 credit hours
- Masters or Professional students . . . . at least 8 credit hours
- PhD students having a Masters degree or 21 hours toward their PhD. . . . . at least 6 credit hours

- Faculty and Staff must be 100% full-time (40 hrs./week) regular employees and be eligible for University paid staff benefits.

Exceptions who also qualify:

- Seniors in their last semester prior to graduating only need to be carrying enough credits to graduate.
- Graduate students who are either Teaching Assistants, Graduate Assistants, or Research Assistants, need to be carrying a combination of credit hours and employment percentage to add up to 100%. (Example: A Masters student who is carrying 6 credit hours and a 25% appointment.)
- Faculty in Architecture & Urban Planning are considered full-time with an 80% appointment.
- Emeritus faculty who have an active status with any appointment percentage.
- Tenure track faculty of the Medical School who are employed at the VA Hospital. (A memo is required from Henry Swain, Associate Dean of the Medical School stating tenure or tenure track status.)

All questions and appeals concerning eligibility should be directed to Photo and Campus Services at the address above or by calling 313/764-9216.

WHERE AND WHEN WILL I RECEIVE MY SYSTEM?

Systems are to be picked-up on **Saturday, February 7, 1987** and **Sunday, February 8, 1987** at:
The University of Michigan North Campus Commons
2101 Bonisteel Blvd., Ann Arbor, Michigan

Confirmation of your order and a scheduled time for the pick-up of your system will be sent to the mailing address listed on the reverse side.

HOW CAN I GET MORE INFORMATION?

Due to the volume of purchasers and the intent to keep University costs low, additional information will be available in only two ways:

- Packets of information will be available beginning December 22, 1986 at the following locations: All Computing Center Public Facilities (UNYN, NUBS, UGL, SPH, Residence Halls, etc.), The Microcomputer Education Center, Campus Information Center, and Photo and Campus Services.
- Seminars will be offered at Auditorium 3 in the Modern Languages Building, 812 E. Washington St., Ann Arbor at the following times:
  Jan. 6, 7-9pm
  Jan. 7, 6-8pm
  Jan.12, 7-9pm
  Jan.14, 7-9pm
  Jan.20, 7-9pm
  Jan.21, 5-7pm
  Jan.26, 7-9pm
  Jan.28, 7-9pm

2012

MICHIGAN STATE UNIVERSITY

COMPUTER LABORATORY

EAST LANSING • MICHIGAN • 48824

BASE

May 6, 1983

RECEIVED
MAY [illegible]
M.R.H.A.

Thomas Aitken
MICHIGAN RETAIL HARDWARE ASSN., INC.
4414 South Pennsylvania Avenue, P.O. Box 30085
Lansing, MI 48909

Dear Mr. Aitken:

Most Michigan residents realize that the Michigan State University Agricultural Experiment Station and Cooperative Extension Service serve the Michigan agricultural community as well as faculty and students on campus.

However, the Michigan business community is generally not aware of the advice and service available to them through the Michigan State University Computer Laboratory. The enclosed article tells something about our service and we're sure it would be of interest to your membership.

Sincerely,

Donald F. Spyke
Business Manager
Computer Laboratory

DFS/DMG

As more and more Michigan businesses realize the importance of the computer as a management tool, the primary dilemma facing them is how to get started.

The Michigan State University Computer Laboratory, as an adjunct to its on-campus teaching and research role, has helped usher many Michigan small businesses into the age of computers.

The Computer Laboratory not only offers non-credit "short courses" for State residents and businesses, but also provides consultation in statistical computing and mini-computer and micro-computer usage.

One of the numerous Michigan businesses taking advantage of the MSU expertise and its large Computer Center is Snell Environmental Group, a Lansing engineering consulting firm with international offices. Pratap Rhajahyasha, Snell's Information Systems Manager, says Snell personnel use programs developed at MSU, other universities, or the federal government, which are a part of the "program library" at the Computer Center. Some of the programs are for engineering applications, while others deal with operational efficiencies such as EDITOR, a text formatting and editing program which facilitates revisions and updates. He also maintains that Snell employees are continually finding new ways to improve efficiency through use of the Computer Laboratory services.

Fishbeck, Thompson, Carr, and Huber, another Lansing-based firm of consulting engineers, makes primary use of the MSU system in management of its business. To efficiently monitor costs and hours spent on any of their national environmental and structural engineering accounts, they use a COBOL (COmmon Business Oriented Language) program to monitor project man-hours and dollars.

Both of these firms, as do over 100 others, maintain and add programs as needed. Fishbeck, Thompson, Carr, and Huber recently added a Storm Water Design program in addition to a Water Analysis program already being used. They also use the MSU computer from their own offices through telephone modems and computer terminals.

Other firms make use of the Computer Laboratory through its role as a Census Data Center or to access any of the 1000 plus programs in its program library.

For information on the MSU Computer Laboratory services, contact:

Donald F. Spyke
Computer Laboratory
220 Computer Center
Michigan State University
East Lansing, MI 48824-1042
(517) 355-5002

042283

By Tim Goheen

sentenced

ov. 7 to the two charges.

Earlier Monday, 29th Circuit ourt Judge Randy Tahvonen sennced Richards in Clinton County r five to 15 years in a state prison r third degree criminal sexual nduct involving a 12-year-old boy.

In Richards' case, third degree iminal sexual conduct involves sexl penetration with a person 13 to 5 years old and fourth degree iminal sexual conduct involves sexl contact.

Computer sellers feel bite from university sales

By KERRY McKEAN
State News Staff Writer

LANSING — Computer retailers are slated to meet with members of the Michigan State Chamber of Commerce today to air gripes surrounding computer sales by state universities.

Computer retailers charge that universities have been buying large numbers of computers from manufacturers at substantial discounts and are passing the low prices on to customers. They claim the universities' actions are cutting into the retail computer market.

"The University (of Michigan) is operating as a multimillion-dollar retailer," said Rick Weir, owner of the Complete Computer Center in Ann Arbor. "I feel very strongly that the university has overstepped its bounds."

Retailers hope to get relief from university competition through meetings with the chamber of commerce and a new House bill introduced by Rep. Margaret O'Conner, R-Ann Arbor.

O'CONNOR'S BILL — which has been sent to the House Colleges and Universities Committee for review — would prohibit university computer sales at prices that undercut retailers.

"If you really believe in the free enterprise system, universities shouldn't be selling these things way below cost," O'Connor said.

Although retailers said the problem is most serious at U-M, some Lansing retailers also said they have felt the crunch created by MSU's computer sales.

"(The University) gets a very advantageous rate because of their volume," said Ed Souders, owner of Entre Computer Center, 300 N. Clippert St., Lansing. "When we lose (a sale), we don't know if we lost it to one of our competitors or the University."

Kirk Bailey, manager of Integrated Computer Systems, 5858 Aurelius Road, Lansing, said he also has lost sales to customers who turned to the University as a source of computers.

"WHEN YOU propose a system, they say they can get it cheaper (from the University)," Bailey said.

MSU computer store administrator Susan Hazard said 359 systems have been sold through the University this year at discounts ranging from 15 percent to 50 percent off the list price.

University officials maintain the program is simply an educational opportunity intended to introduce computers to students and University employees.

"It's a service. We don't make money," said Peter Lyman, MSU's assistant director of academic computing. "We want to encourage members of the MSU community to use computers. Selling them is just part of the general attempt to encourage the use of computers."

The University tries to ensure that the educational discount is not misused by requiring customers to present University identification and by allowing only one computer purchase per person each year, Hazard said.

EVEN WITH such restrictions, retailers claim the universities' lack of overhead and taxes allow them to undercut prices to a point retailers are unable to match.

"The University doesn't pay any taxes," Weir said. "They're competing unfairly. They're reselling products in unfair competition with the private sector."

Souders said he was concerned his business was required to pay taxes that help support the University.

"I have a little bit of a problem with my tax dollars being used . . . in competing against me," he said.

Betty's Buttons
Sororities and

CASH FOR NEW DONORS

10/10/85

Detroit News.

Xerox 10 copies

arrangement will drive down Canadian prices, through intensification of competition and

tionism elsewhere around the world these days.

Computer Cartel in Ann Arbor?

The University of Michigan wants its students and staff to own personal computers. We heartily endorse this boosting of an educational, research, and writing resource, the value of which few dispute. But in pursuing this goal, the university risks unnecessary damage to Ann Arbor's energetic business community through a system that will, in effect, give the university a monopoly on computer retailing in the area.

Beginning in 1984, computer specialists at a microcomputing center on campus began helping students, teachers, and other university staff members determine their computing needs. The center then purchased Apple computers at close to wholesale prices and offered them to the students at prices no retailer could match. Now the university is expanding its business through a similar deal with IBM.

The university tried to placate the local computer dealers, alarmed at the prospect of seeing their IBM business go the way of Apple (down roughly 50 percent), by offering to let them be the outlets through which the university's computer business would be transected. In effect, this means that if a dealer agrees to the university's prices, for a modest fee he can have the honor of delivering equipment to the university's customers. This is not what most businessmen have in mind when they invest in a store.

It is perfectly understandable that the University of Michigan should want to keep life as inexpensive as possible for its students, especially in a period when the state is hard pressed to come up with the funding needed to maintain it in its position among the nation's great universities.

But to go into retail competition with the businesses that have helped make Ann Arbor a boom town raises serious questions of fairness. A similar pattern developed in the book business some years back, with the university-sponsored book cooperative gradually squeezing a number of other booksellers in Ann Arbor out of business.

Keeping student costs down is a legitimate interest of the university and the state. But the state — and the university — also have a legitimate interest in not doing violence to honest businesses struggling to make a buck. Those businesses, after all, add substantially to the state's tax base on which the state's universities must ultimately depend. And they invested their own funds, at considerable risk to themselves and no risk to the state, to begin job-creating enterprises in an industry that didn't even exist a few years ago.

Creating a university cartel in computers might save students some money in the short run, but it could wind up costing money in the long run. The private sector is much quicker to adapt to the needs of its consumers and to changes in technology as they come along. A cartel, even one run by well-intentioned academics, is likely to be much less efficient over time.

So the educational establishment should resist the shortsighted temptation to cream off the best of the personal computer business in Ann Arbor, Lansing, and elsewhere. It would be a clear signal to high-tech business that the state isn't interested in the jobs it creates. And it would confirm many potential investors in their belief that Michigan looks upon "profit" as something evil, or at least unnecessary. The university should buy the computers it needs for its classrooms, and leave the rest to the students and the pioneer computer retailers in Ann Arbor.

Postscripts

Making Hash of Lebanon

The civil war in Lebanon has dragged on since 1976. Syrians have invaded. The Palestine Liberation Organization has wreaked havoc. Israel has invaded. Yet the Lebanese economy — though no longer flourishing as it once was — still supports a fair-sized population without begging from the International Monetary Fund or Citibank. How does it do this? Hashish, that's how. The country's chief export crop is "Lebanese Red." Although it's theoretically illegal in Lebanon, legality is a spotty concept where there is no government.

go abroad. Maybe the turmoil in Lebanon isn't as pointless as it sometimes appears.

Bypass Surgery on the Budget

Good grief! The U.S. Treasury went out and sold $5 billion of new securities yesterday — without, so far as we can tell, any legislative authority. Indeed, the government had bumped up against its legal debt ceiling, which has been causing the usual elbowing, gnashing of teeth, and other displays of good intentions up on Capitol Hill this week. As of late yesterday, the debt ceiling still had not been raised, but a Treasury official said nobody would mind just a *little* infusion of funds to keep the government running and prevent the

White Star
PROFESSIONAL
FILM SERVICES, INC.

LABORATORY
16641 AIRPORT RD.
LANSING, MICHIGAN 48906
PHONE: (517) 321-1776

April 29, 1987

Ms. Martha Andrews
BASE
P.O. Box 20171
Lansing, MI 48901

Dear Ms. Andrews:

Attached herewith is my file on the I.M.C. (MSU) problem.

Also, you will find the article on our "First Lady's" venture, letters, etc.

I hope this will be adequate - if not please give me a call.

Sincerely,

Richard G. Cole

Enclosures

RGC/clo

ACVL

White Star
PROFESSIONAL
FILM SERVICES, INC.

LABORATORY
16641 AIRPORT RD.
LANSING, MICHIGAN 48906
PHONE: (517) 321-1776

June 9, 1986

Representative Debbie Stabenow
Cpaital Building
P.O. Box 30014
Lansing, MI 48909-7514

Dear Representative:

I very much appreciated the opportunity to speak-out the other day. My sincere hope now is that it will help bring the present (and past) practices to an end. To date all we have had are promises!

As promised I am sending, along with this letter, copies of the M.S.U. client list. This is the list they send out with their quotes and proposals.

Should you want or need any further information, please feel free to call me.

Sincerely,

Richard G. Cole
President

Enclosure

RGC/clo

ACVL

They (not) should
the source
these MSU departm
OK.

CAMPUS DEPARTMENTS & AGENCIES cont'd
Page 3

Office of Women's Programs
Olin Health Center
Orientation Program
Osteopathic Medicine
Owen Graduate Center
Packaging
Panhellenic Council
Parks & Recreation Resources
Pathology
Pediatrics & Human Development
Personnel & Employee Relations
Pesticide Research
Pharmacology & Toxicology
Philosophy
Physical Plant
Physics/Astronomy
Physiology
Placement Bureau
Plant Research Lab
Political Science
Poultry Science
President's Office
Provost
Psychiatry
Psychology
Public Relations
Public Safety
Purchasing
Racial & Ethnic Studies
Radiation Safety
Radio Board, MSU
Radiology
Red Cedar Log Book
Registrar
Research Development, Office of
Research Information
Residence Hall Association
Resident & Graduate Studies
Resource Development
Romance & Classical Languages
Scene, MSU
Science & Math Teaching Center
Secondary Education & Curriculum
Shaw Hall
Small Animal Surgery & Medicine
Snyder-Phillips Hall
Social Science, College of
Social Work
Sociology
Spartan Nursery School
Special Programs
Sports Publicity
State News
Statistics & Probability
Student Affairs
Student Teaching
Surgery
Teacher Education
Telecommunications
Theatre
Undergrad, University Division
Union Building
United Ministries in Higher Education
University Apartments
University Archives & Historical Collectic
University Center for International
  Rehabilitation
University Farms
University Housing Program
University Printing
University Services
Urban Affairs, Center for
Urban Development, College of
Urban Planning & Landscape Architecture
Veterinary Medicine, College of
Vice President, Student Affairs
Water Research, Institute of
West Circle Halls
Wilson Halls
WKAR Radio
Wonders Hall
Yakeley - Gilchrist Hall
Youth Sports
Zoology

CLUBS, ASSOCIATIONS & AGENCIES

Certainly NOT any of these

✓ FL-CIO
✓ Alumni Association, MSU
✓ American Cancer Society
✓ American Red Cross
✓ AP Association
✓ Association for Child Development

CLUBS, ASSOCIATIONS & AGENCIES cont'd
Page 4

Association of Students, MSU
Beal Film Group
Business Women's Club, MSU
CELA
Classic Films
Community Mental Health/Ionia County
Consumers Power Company
Ella Sharp Museum
Faculty Women's Association
Finance Club, MSU
First United Methodist Church
Friends of the [illegible]
General Union of Palestinian Students
Greater Lansing Board of Realtors
HIS House Fellowship
India Club
Indian Economic Institute
Informed Choices of Childbirth
Interfraternity Council
Jewish Human Rights Council
Junior League of Lansing
Labor Program Service
Maranatha Christian Fellowship
Michigan Animal Breeder Coop
Michigan Association of Conservation District
Michigan Bar Association
Michigan Beef Industry Commission
Michigan Building Trades Council
Michigan Economics for Human Development
Michigan Health Council
Michigan Heart Association
Michigan Historical Museum
Michigan Prime Forest Land Development Project
Michigan Special Olympics
Middle East Peace Action Coalition
MSU Employees Association
MSU Employees Credit Union
MSU Foundation
MSUMA
MSU, Right to Life
MSU, Varisty "S" Club
New Morning Film Group
Peace Corps Rec.
Railroad Club
Saint Norbert College
Sexual Assault Crisis Program
Sparrow Hospital
State Journal
Student Nurses Association
USDA-FMHA
USDA Forest Service
USDA Regulatory Poultry Lab
USDA Soil Conservation Service
United Students for Christ
Wayne County Public Schools, Vocational Technical

STATE AGENCIES

Governors Office
House Appropriations Committee
House Fiscal Agency
Legislative Apportionment Committee
Michigan Department of Commerce
Michigan Department of Education
Michigan Department of Labor
Michigan Department of Management & Budget
Michigan Department of Mental Health
Michigan Department of Corrections
Michigan Department of Natural Resources
Michigan Department of Social Services
Michigan Department of State
Michigan Department of Traffic Safety
Michigan Department of the Treasury
Michigan Occupational Information System
Michigan State Police
Michigan Supreme Court
Ohio Department of Natural Resources
Senate Fiscal Agency

In additions, films from our Film Library are rented to colleges, universities and professional organizations all over the USA.

Faculty developed instructional materials were marketed to 685 organizations in the USA and 14 countries overseas.

White
PROFESSIONAL
FILM SERVICES, INC.

LABORATORY
16641 AIRPORT RD.
LANSING, MICHIGAN 48906
PHONE: (517) 321-1776

March 25, 1987

Mrs. Paula Blanchard
[illegible]
Telecommunications Dept.
Michigan State University
East Lansing, MI

Dear Mrs. Blanchard:

For the past years we have struggled as a small business here in Lansing. Every year seems to be more of a problem. One of our problems has been the public jurisdictions (universities) competing with us (the private sector). Now right at the peak of this problem you want to make "a big production of M.S.U.'s telecommunications talents" as stated in the front page article of the Lansing State Journal - March 18, 1987. I can't believe this! What more can I say or do? Please read the attached letters, and you will have a better idea of what has happened - and what BASE, Senator Sederberg, Representative Stabenow, and many other concerned free enterprisers are trying to do about it.

I have called your office twice, but can't seem to get a reply, so decided I had better put my concern in writing.

Sincerely,

Richard G. Cole

Richard G. Cole

Enclosure

RGC/clo

BUSINESSES & ASSOCIATIONS FOR A STRONG ECONOMY
P.O. Box 20171 • Lansing, Michigan 48901 • (517) 374-0860

BASE AGENDA

8:30 A.M. Friday, January 9
Room 471 Roosevelt Building
222 N. Seymore
Lansing, Michigan

MODERATOR:

[illegible], Vice Chairman

GUESTS INVITED:

Senator William Sederburg, Representatives from Universities. "Please notify friends or members who are interested in discussing current problems of UNIVERSITY COMPETITION."

Please bring guests to this meeting who have problems with competition.

FUTURE MEETINGS:

8:30 A.M. Friday, February 6th, Roosevelt Building, room 471. Jo Knechtges, Correctionist Specialist , from Senator Wilborn's office..Report on Prison Industry Investigation.

8:00 A.M. Thursday, February 5th. Board of Directors meeting. Call Marty for place and time if you can attend.

8:30 A.M. Friday, March 6th, Roosevelt Building, room 471. We hope to have Mr. John Morburg back as our guest.

PLEASE MARK YOUR CALENDARS as we may not send another announcement for the next two meetings.

Martha A. Andrews (Marty)
Martha A. Andrews
Chairperson

BASE

White Star
PROFESSIONAL
FILM SERVICES, INC

LABORATORY
16641 AIRPORT RD.
LANSING, MICHIGAN 48906
PHONE: (517) 321-1776

November 26, 1985

Governor James J. Blanchard
[illegible]
[illegible]

Dear Governor Blanchard:

I feel that I just can't allow this latest situation to go by unnoticed.

First, please refer to my previous letters dated September 10, 1984, and October 22, 1985.

Now to make our situation even worse we must compete with our tax supported institutions! We spent a total of 60 man hours preparing a quotation for the Department of Management and Budget. This quotation covered the production of 4 T.V. spots for the Department of Treasury.

No storyboards or scripts were available for bidding, so it was a "pig-in-a-poke" situation. We explained this in detail and bid $20,000.00 , with the promise to come in under this figure, if we had some control over the creative development of final scripts.

Yesterday we received the enclosed letter from the Department of Management and Budget. The Instructional Media Center is Michigan State University! Is it any wonder they can bid $1,060.00 less? Where do they pay their taxes? Who pays for their overhead - ? etc. etc. This is not the first time this has happened, and if this situation goes unnoticed, it won't be the last?

I must quote the last paragraph of my October 22, letter, "Now we want very much to stay in business, stay in Lansing, and most importantly stay in Michigan. Is there anything that can be done in your office to assist us in any way?" I don't believe I need to say anymore.

Most Sincerely,

Richard G. Cole
President

RGC/clo

JAMES J. BLANCHARD, Governor

DEPARTMENT OF MANAGEMENT AND BUDGET

P.O. BOX 30026, LANSING, MICHIGAN 48909
ROBERT H. NAFTALY, Director

December 9, 1985

Mr. Richard G. Cole, President
White Star Professional Film Services, Inc.
16641 Airport Road
Lansing, Michigan 48906

Dear Mr. Cole:

Your letter to Governor Blanchard has been forwarded to me for response as the Office of Purchasing is a component of my department. The concern that you have raised regarding universities and other public jurisdictions competing against private enterprise is valid. The present purchasing process provides equal opportunity for anyone interested in providing commodities and/or services to the State. The Office of Purchasing, at my direction, is currently working on a revised Administrative Manual procedure which will inform the State departments of the types of services where colleges and universities will be allowed to participate. While this procedure will not be issued until January, 1986, it is generally going to prohibit competition in those areas where the private business sector can offer the service.

This administration has a strong commitment in improving the business climate in the State of Michigan, and to encourage new and expanding businesses. One of the ways is to insure that the State's procurement practices reflect this commitment. There are certain areas where the educational community is able because of their educational and research responsibilities to offer things that are unavailable through the private sector. To that end, we would intend on only soliciting proposals from that arena. Conversely, there are far more services where the private sector should not find itself in competition with educational institutions for the very reasons stated in your letter.

I want to thank you for taking the time to communicate your concerns with the Governor. It is letters such as this that reinforce our effort to build a procurement process which will be equitable to everyone.

Sincerely,

Robert H. Naftaly
Director

MICHIGAN STATE UNIVERSITY

DEPARTMENT OF TELECOMMUNICATION
(517) 355-8372

EAST LANSING • MICHIGAN • 48824-1212

April 3, 1987

Mr. Richard G. Cole
White Star Professional Film Services Inc.
10641 Airport Rd.
Lansing, MI 48906

Dear Mr. Cole:

I received your letter and am happy to have the opportunity to address your concerns.

TELSTATE is an audio/video production unit in the Department of Telecommunication at Michigan State University. Its sole purpose is to provide our undergraduate and graduate students with practical knowledge of the production field by giving them an opportunity to work on production projects for clients. These clients will come primarily from the University. In that respect we are operating as an "in-house" production facility. In the event we do projects outside the university, they will be confined to other public institutions.

The TELSTATE program supplements the academic program of our department. We have a responsibility to give our students the best education and training possible. TELSTATE is one of many efforts to do that.

I hope this will help clarify TELSTATE and its purpose for you.

Sincerely,

Paula Blanchard

Paula Blanchard
TELSTATE Director

PB:bs

Aint life" and
"Thank you Von FEKNIKA,
nuts SHARP, MPD,
GALAXY etc.

A Gannett Newspaper Copyright © 1987 Lansing State

“I'd like to have my own company in the next five years.” — Paula Blanchard

Lansing State Journal/ROD SANFOI

Paula Blanchard sits at a control panel in a video studeo at MSU. Blanchard proposed and implementing a program designed to give telecommunications students practical experien in creating a variety of video productions.

TELSTATE

Paula Blanchard details her professional goals

By KATHY BARKS HOFFMAN
Lansing State Journal

First lady Paula Blanchard wants to make a big production of Michigan State University's telecommunications talents.

She has signed a contract with MSU to create TELSTATE, an audio-video production unit that will enable telecommunications students to turn out everything from public service announcements to training films.

The group expects to have its first productions ready this spring, she said.

Blanchard proposed TELSTATE because she believed telecommunications students weren't getting enough hands-on, real-world experiences before they graduate.

She expects to finish her master's degree in telecommunications at MSU in June.

“As a student in this department, I found the opportunity for outside work was limited,” said Blanchard, who began her degree work in January 1985.

She produced a documentary and other pr grams. But Blanchard said too many MSU telcor munications students don't have samples of ot side work to show prospective employers when they graduate.

She got the idea for TELSTATE last fall and submitted a proposal to the telecommunications department in January, the same month she closed her office in the state Commerce Department.

As the driving force behind the Commerce Department's Office of Products Promotion, Blanchard worked for free the past four years. Under her Feb. 1 to June 30 contract with MSU, she will work 20 hours a week and receive $6,250.

She shares an office on the fourth floor of the Communication Arts Building with another graduate student. Her standard-issue green metal desk is decorated with a photo of her son, Jay, and a radio.

See BLANCHARD, Page 2A

Blanchard

From 1A

Blanchard said her new interest doesn't mean she's giving up her first lady duties.

She will continue to promote Michigan products, travel and tourism, and has started the Michigan 150 First Lady Awards Program to recognize 150 living Michigan women.

She wants to get more involved in human services, particularly those for children. And she said her responsibilities as wife of Gov. James Blanchard and mother of their teen-age son remain a high priority.

In the meantime, she plans to concentrate on TELSTATE. Blanchard envisions students and faculty working together on about six [illegible] each 10-weeks term once the program gets rolling.

Most of the projects probably will be for the university or nonprofit groups, she said.

Students will not receive class credit for their work but will be paid for the hours they work, she added. They also will have tapes or cassettes with their names in the credits to show future employers.

Blanchard hopes MSU will hire her again next fall to continue shepherding TELSTATE, although she doesn't know how long she'll stay with the program.

“I have my own personal and professional identity here,” she said of her work at MSU. “That's one of the reasons I enjoy being here so much.”

This is the R.F.B
Did MSU-(IAIC) measure up to all the requirements?
NO

See I-T, I-U, I-V, I-W
III-A, —— ?

RETURN BID TO:
DEPARTMENT OF MANAGEMENT AND BUDGET
OFFICE OF PURCHASING
STEVENS T. MASON BLDG., 2ND FLOOR
P.O. BOX 30026
LANSING, MICHIGAN 48909

STATE OF MICHIGAN

FORM DMB 283 (REV. 5

REQUEST FOR QUOTATION

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XXXXX  XXXXX  X   X  XXXXX  XXXXX  XXXX           XXXX   X  XXXX
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NOTICE

In order to protect the integrity of the sealed bid process, failure to properly identify your sealed bid according to the instructions below will result in an automatic disqualification from consideration. There will be no exceptions and failure to comply will not be considered a basis for filing a vendor appeal. Each of the items below are absolutely essential and an integral part of the sealed bid process.

INSTRUCTIONS:

1. Bid must be returned in a separate envelope.
2. Envelope must be clearly indicated with the following:
    a. The notation 'SEALED BID'
    b. The Bid Number (85TR0423)
    c. Your company name (WHITE STAR PROFESSIONAL FILM)
    d. Your Bidder Number (05414)
    e. The Date Due (10/16/85)
    f. The Time Due (2:00 P.M.)
3. The completed envelope must be received at the Office of Purchasing and stamped in by the indicated date and time
    a. It must be delivered to the receptionist desk

       OR

    b. It must be mailed to:

Department of Management & Budget
Office of Purchasing
Stevens T. Mason Bldg., 2nd Floor
P.O. Box 30152
Lansing, Michigan 48909

RETURN BID TO:
DEPARTMENT OF MANAGEMENT AND BUDGET
OFFICE OF PURCHASING
STEVENS T. MASON BLDG., 2ND FLOOR
P.O. BOX 30026
LANSING, MICHIGAN 48909

STATE OF MICHIGAN

REQUEST FOR QUOTATION

PAGE 1

FORM DMB 285 (REV. 5

SEALED Bid Due
10/16/85
BY 2:00 P.M.

Direct Questions To:	Date Issued:	Delivery Required:	Bid Number:
R. IRVINE	09/30/85		85-TRQ423

DEPARTMENT OF TREASURY

Quote F.O.B.:
DELIVERED

Bidder: 05414

WHITE STAR PROFESSIONAL FILM
SERVICE INC.
16641 AIRPORT ROAD
LANSING MI 48906

Ship To:

MICHIGAN DEPT. OF TREASURY
ATTN: PROCUREMENT SECTION
3RD FLOOR, TREASURY BLDG.
LANSING MI 48922

BIDDER READ AND COMPLETE

The undersigned certifies that he/she offers to furnish materials in strict accordance with the requirements of this bid including instructions and conditions on the reverse side; that prices quoted are correct; and that this bid may not be withdrawn for a period of 30 days from the due date noted above.

Cash Disc _______________30 Days
Shipment _______________Days ARO
F.O.B. _______________________
Ship Pt. _______________________
Est. Ship Wt. ___________________

____
Signature [IN INK] Date

Federal ID No. 38-2182831

Total Bid $____________________

Authority: Act 431 of 1984. Completion: Voluntary.

ATTACHMENTS:
SPECIFICATIONS, TERMS, AND CONDITIONS PER ATTACHED.

GENERAL REQUIREMENTS:
SEE ATTACHED FOR DETAIL.

PURCHASING USE ONLY

WHITE STAR PROFESSIONAL FILM
C
5
4
1
4

RETURN BID TO:
DEPARTMENT OF MANAGEMENT AND BUDGET
OFFICE OF PURCHASING
STEVENS T. MASON BLDG., 2ND FLOOR
P.O. BOX 30026
LANSING, MICHIGAN 48909

STATE OF MICHIGAN

REQUEST FOR QUOTATION

FORM DMB 285 (REV. 5/

PAGE 2

Direct Questions To:	Date Issued:	Delivery Required:	Bid Number:
R. IRVINE	09/30/85		85-TR0423

DEPARTMENT OF TREASURY	Bidder: 05414 WHITE STAR PROFESSIONAL FILM

EXPERIENCE IN PRODUCING SIMILIAR ADVERTISEMENTS OR PSA'S. TREASURY REQUIRES THAT BIDDERS BE PREPARED TO SHOW EXAMPLES OF PREVIOUS WORK WHICH HAS BEEN BROADCAST. BIDDERS MUST ALLOW REPRESENTATIVES OF THE OFFICE OF PURCHASING, MANAGEMENT & BUDGET AND THE DPEARTMENT OF TREASURY TO VIEW THEIR FACILITIES BEFORE THE CONTRACT IS AWARDED TO BE SURE THE BIDDER IS CAPABLE OF PROVIDING THE SERVICES REQUIRED. SELECTION CRITERIA REGARDING AWARD OF THIS CONTRACT ARE DETAILED IN PARAGRAPH I-L OF THE ATTACHED REQUEST FOR PROPOSAL (RFP). SEE RFP FOR DETAIL.

ITEM

001 THE DEPARTMENT OF TREASURY WILL PRODUCE FOUR (4) PUBLIC SERVICE ANNOUNCEMENTS (PSA'S) FOR DISTRIBUTION TO ALL COMMERCIAL AND PUBLIC TELEVISION AND RADIO STATIONS IN MICHIGAN. EACH PSA WILL BE 30 SECOND LONG. THE FOUR PSA'S WILL BE ABOUT THE FOLLOWING:

1. ANNOUNCING THAT STATE FORMS WILL BE MAILED RATHER THAN DISTRIBUTED AT BANKS, POST OFFICES, ETC. AS HAS BEEN DONE IN PAST YEARS.
2. HOMESTEAD PROPERTY TAX CREDIT CLAIM FORMS MI-1040CR-1, CR-3 AND CR-4 WILL BE COMBINED.
3. TOLL-FREE TAX ASSISTANCE TELEPHONE NUMBER.
4. FREE TAXPAYER ASSISTANCE AT TREASURY BRANCH OFFICES.

ITEM	QUANTITY	UNIT	MICHIGAN CODE	UNIT PRICE	AMOUNT
.01	4	EA	6005-		

PUBLIC SERVICE ANNOUNCEMENTS ABOUT INCOME TAX AND HOMESTEAD PROPERTY TAX CREDIT CLAIM CHANGES.

(CONTINUED)

TURN BID TO:
PARTMENT OF MANAGEMENT AND BUDGET
FICE OF PURCHASING
EVENS T. MASON BLDG., 2ND FLOOR
). BOX 30026
G, MICHIGAN 48909

STATE OF MICHIGAN

REQUEST FOR QUOTATION

FORM DMB 285 (REV. 3/83)

PAGE 3

irect Questions To: R. IRVINE	Date Issued: 09/30/85	Delivery Required:	Bid Number: 85-TR0423
EPARTMENT OF TREASURY		Bidder: 05414 WHITE STAR PROFESSIONAL FILM	

TEM

VENDOR TO BE RESPONSIBLE FOR THE FOLLOWING:
1) PROVIDING CONSIDERABLE GUIDANCE AND ADVICE ON BOTH AUDIO AND VIDEO PORTIONS
2) ASSISTING DEPARTMENT IN SECURING TALENT TO APPEAR IN THE PSA'S. VENDOR MUST ARRANGE FOR AUDITIONS, GUARANTEE THAT ACTORS HIRED WILL PERFORM THEIR DUTIES. PAY PERFORMERS. BID SHOULD INCLUDE COSTS ASSOCIATED WITH HIRING TALENT.
3) PROVIDING ALL TECHNICAL SERVICES NECESSARY, INCLUDING BUT LIMITED TO, PHOTOGRAPHY, SOUND RECORDING, EDITING, SPECIAL EFFECTS AND COPY OF PSA'S FOR DISTRIBUTION TO THE MEDIA.

DEPARTMENT OF TREASURY WILL:
1) HAVE A REPRESENTATIVE ON HAND FOR ALL FILMING AND RECORDING SESSIONS.
2) HAVE FINAL CHOICE ON TALENT AND MAKE SCRIPT AND VIDEO DECISIONS.
3) DISTRIBUTE FINISHED PRODUCT (PSA'S) TO THE MEDIA.

PSA'S ARE TO BE DISTRIBUTED TIMELY FOR AIRING/BROADCAST BEGINNING DECEMBER 1, 85. FILIMING MUST BE DONE IN TIMELY MANNER. . FINAL PRODUCTION CHEDULE WILL BE ESTABLISHED BETWEEN VENDOR & DEPT. OF TREASURY.
TO MINIMIZE COST OF PRODUCTION & TIME REQUIREMENTS PLACED ON TREASURY PERSONNEL MANAGING PROJECT, FILIMING & ANY OTHER WORK REQUIRING PRESENT OF TREASURY PERSONNEL MUST BE DONE WITHIN 100 MILES OF LANSING.

***** REQUEST FOR QUOTATION COMPLETE *****

10/2/85

3. Prior Experience

Indicate here prior experience of your firm which you consider relevant to the successful accomplishment of the project defined by this Request For Proposal. Include sufficient detail to demonstrate the relevance of such experience. Include sample PSA's as explained in I-L (A) and I-L (C). Also, include the name, address, and phone number of the responsible official of the client organization who may be contacted as required in I-L (B).

4. Manpower

The consulting firm must be able to staff a project team which possesses talent and expertise in the field of PSA production. Include the number of executive and professional personnel by skill and qualification that will be employed in the work. Show where these personnel will be physically located during the time they are engaged in the work. Identify key individuals by name and title. Resumes of qualifications are required for proposed project personnel as explained in I-L (B).

5. Subcontractors

List all subcontractors, include firm name and address, contact person, complete description of work to be subcontracted. Include descriptive information concerning subcontractor's organization and abilities.

III-D PRICE PROPOSAL

The information requested in this section is required to support the reasonableness of your quotation. THIS PORTION OF THE PROPOSAL MUST BE BOUND AND SEALED SEPARATELY FROM THE REMAINDER OF THE PROPOSAL. Use the format below:

1. Manpower Costs. Itemize so as to show the following for each category of personnel with a different rate per hour:
   a. Category; e.g., project manager, senior analyst, etc.
   b. Estimated hours.
   c. Rate per hour.
   d. Total cost for each category and for all manpower needs.
2. Cost of Supplies and Materials. Itemize.
3. Other Direct Costs. Itemize.
4. General and Administrative Burden or Overhead. Indicate percentage and total.

5. Transportation Costs. Show travel costs and per diem separately.

6. Total Price Bid for Project.

7. Independent Price Determination. Include a statement substantially as follows:

> 'This cost and price analysis is submitted in full compliance with the provisions of the paragraph titled 'Independent Price Determination' in Part I of the RFP to which this proposal is a response."

III-E BIDDER'S AUTHORIZED EXPEDITOR

Include the name and phone number of person(s) in your organization authorized to expedite any proposed contract with the State.

III-G ADDITIONAL INFORMATION AND COMMENTS

Include any other information that is believed to be pertinent but not specifically asked for elsewhere.

III-H PROPOSAL SUBMITTAL

Submit 4 copies of your response in accordance with the following instructions:

1. SEALED BIDS (PROPOSALS) MUST BE RECEIVED AT THE OFFICE OF PURCHASING AND TIME-STAMPED BY THE OFFICE OF PURCHASING NOT LATER THAN 2:00 P.M. ON October 16, 1985.

2. Submit with your proposal the cover sheet (Form DMB-285) sent with this Request. PROPERTLY COMPLETE AND SIGN THAT FORM BEFORE SUBMITTAL.

The Office of Purchasing address for proposals submitted by Contract Carrier, Courier Delivery, or hand delivery is:

State of Michigan
Department of Management and Budget
Office of Purchasing
2nd Floor, Mason Building
530 West Allegan Street
Lansing, MI 48933

Proposals submitted through the U. S. Postal Service should be addressed as follows:

State of Michigan
Department of Management and Budget
Office of Purchasing
Post Office Box #30152
Lansing, MI 48909

SECTION I
GENERAL INFORMATION FOR BIDDERS

I-A PURPOSE

The purpose of this Request For Proposal (RFP) is to obtain quotations for production of four public service announcements (PSA's) for distribution to all commercial and public television and radio stations in Michigan. Each PSA will be 30 seconds long. The radio stations will receive just the audio portion of the PSA. The four PSA's will be about these topics:

1. Announcing that state forms will be mailed rather than distributed at banks, post offices, etc. as has been done in past years.
2. Homestead proprerty tax credit claim forms MI-1040CR-1, CR-3 and CR-4 will be combined.
3. Toll-free tax assistance phone no.
4. Free taxpayer assistance at Treasury branch offices.

I-B ISSUING OFFICE

This RFP is issued by the Office of Purchasing, State of Michigan, Department of Management and Budget (DMB), hereafter known as the Office of Purchasing, for the State of Michigan, Department of Treasury. Where actions are a combination of those of the Office of Purchasing and Department of Treasury, the authority will be known as the State.

The Office of Purchasing is the sole point of contact in the State with regard to all procurement and contractual matters relating to the services described herein. The Office of Purchasing is the only office authorized to change, modify, amend, alter, clarify, etc., the specifications, terms, and conditions of this Request For Proposal and any contract(s) awarded as a result of this Request. The OFFICE OF PURCHASING will remain the SOLE POINT OF CONTACT throughout the procurement process, until such time as the Direcstor of Purchasing shall direct otherwise in writing. See Paragraph I-C below. All communications this procurement must be addressed to:

Ray Irvine
DMB, Office of Purchasing
2nd Floor, Mason Building
P. O. Box 30026
Lansing, Michigan 48909

I-C CONTRACT ADMINISTRATOR

Upon receipt at the Office of Purchasing of the properly executed Contract Agreement, it is anticipated that the Director of Purchasing will direct that the person named below be authorized to administer the Contract on a day-to-day basis during the term of the Contract. However, administration of any contract resulting from this Request implies no authority to change, modify, clarify, amend, or otherwise alter the terms, conditions, and specifications of such contract. That authority is retained by the Office of Purchasing. The Contract Administrator for this project is:

Janet Norris Cox
Department of Treasury
Office of Public Information and Forms
Treasury Building, Lansing, MI 48922

I-D INCURRING COSTS

The State of Michigan is not liable for any cost incurred by the bidder prior to signing of a contract. The activities in the proposed contract cover the period October 28, 1985 through December 31, 1985. The State fiscal year is October 1st through September 30th. The prospective contractor should realize that payments in any given fiscal year are contingent upon enactment of legislative appropriations.

I-E PRE-BID MEETING/QUESTIONS

A prebid meeting is not scheduled. Questions from vendors regarding this RFP must be submitted in writing and must arrive in the Office of Purchasing (see Paragraph I-B) not later than fourteen calendar days after the "date sent" as indicated at the top of the cover sheet sent with this RFP. All questions must be in writing; telephonic questions cannot be answered. Written answers to questions that change or substantially clarify the RFP will be provided to all prospective bidders.

I-F PROPOSALS

To be considered, each bidder must submit a COMPLETE response to this RFP, using the format provided in Section III. No other distribution of proposals is to be made by the bidder. The PROPOSAL MUST BE SIGNED IN INK BY AN OFFICIAL OF THE BIDDING ORGANIZATION authorized to bind the bidder to its provisions. BIDDERS MUST ALSO COMPLETE, SIGN, AND RETURN THE COVER SHEET (FORM DMB 285) SENT WITH THIS RFP. The proposal itself must include a statement as to the period during which the proposal remains valid. This period must be at least sixty days from the due date for responses to this RFP.

#1

I-G ORAL PRESENTATION

Bidders who submit proposals may be required to make oral presentations of their proposals to the State. These presentations provide an opportunity for the bidders to clarify the proposals through mutual understanding. The Office of Purchasing, DMB, will schedule these presentations, if required.

I-H ACCEPTANCE OF PROPOSAL CONTENT

The contents of this RFP and the proposal will become contractual obligations, if a contract ensues. Failure of the successful bidder to accept these obligations may result in cancellation of the award.

The State further reserves the right to interview the key personnel assigned by the successful bidder to this project and to recommend reassignment of personnel deemed unsatisfactory by the State. The State reserves the right to approve subcontractors for this project and to require primary contractors to replace subcontractors who are found to be unacceptable.

I-J PRIME CONTRACTOR RESPONSIBILITIES

The Prime Contractor will be required to assume responsibility for all contractual activities offered in this proposal whether or not that contractor performs them. Further, the State will consider the Prime Contractor to be the sole point of contact with regard to contractual matters, including payment of any and all charges resulting from the anticipated contract. If any part of the work is to be subcontracted, responses to this RFP must include a list of subcontractors, including firm name and address, contact person, complete description of work to be subcontracted, and descriptive information concerning subcontractor's organizational abilities. The State reserves the right to approve subcontractors for this project and to require the right to approve subcontractors for this project and to require the Primary Contractor to replace subcontractors found to be unacceptable. The State reserves the right to approve subcontractors for this project and to require the Primary Contractor to replace subcontractors found to be unacceptable. The contractor is totally responsible for adherence by the subcontractor to all provisions of the contract.

I-L SELECTION CRITERIA

Responses to this RFP will be evaluated based upon a two-step selection process. The first step will involve an evaluation of the following factors as presented in the bidder's response to this RFP:

Step I

A. Demonstrated Experience and Expertise (35 Points Possible)

Bidders must submit with their bid at least two samples of video tape advertisements or PSA's which they produced and which have been broadcast on television. These will be used to evaluate the bidder's technical expertise. Bidders must also include a statement listing years in business and previous experience in producing materials for government.

B. Professionalism (30 Points Possible)

Bidders must submit with their bid a resume of each individual who will be assigned to this project. The resume should list relevant educational achievements and years of experience in the type of work each person would be assigned to complete. Bidders must also submit the name, address and telephone number of two previous customers who can be contacted as references regarding the professional conduct of bidders.

C. Creativity (35 Points Possible)

Bidders must submit two samples of previous PSA's or advertisements to be evaluated as evidence of their creativity. These can be the same samples submitted to demonstrate technical expertise, but may be in addition to the others. These samples will be evaluated for use of audio or visual special effects, script quality and overall effectiveness.

Of the total maximum possible score in Step I, a minimum of not less than 85% of the available points must be obtained in order for a bidder to be further considered for award under Step II below.

Step II

A. Price Analysis

Only those proposals receiving a score of 85% or more of the total maximum possible score in Step I will be considered for evaluation in Step II. Of those proposals scoring 85% or more of the total maximum possible score, an award recommendation, subject to B.2 below, will be made to the Director of Purchasing, to that responsive and responsible qualified bidder offering the lowest price for the goods/services offered: the quality of the commodities/services to be supplied, their conformity with specifications, their suitability to the requirements of the State, and delivery terms being taken into consideration.

2. The State reserves the right to award by item, part or portion of an item, group of item or total proposal. The State may reject any and all proposals in whole or in part, and may waive any informality or technical defects if, in the Director of Purchasing's judgment, the best interest of the State will be so

I-M INDEPENDENT PRICE DETERMINATION

1. By submission of a proposal, the bidder certifies, and in the case of a joint proposal, each party thereto certifies as to its own organization, that in connection with this proposal:

    a. The prices in the proposal have been arrived at independently, without consultation, communication, or agreement, for the purpose of restricting competition as to any matter relating to such prices with any other bidder or with any competitor; and

    b. Unless otherwise required by law, the prices which have been quoted in the proposal have not been knowingly disclosed by the bidder and will not knowingly be disclosed by the bidder prior to award directly or indirectly to any other bidder or to any competitor; and

    c. No attempt has been made or will be made by the bidder to induce any other person or firm to submit or not submit a proposal for the purpose of restricting competition.

2. Each person signing the proposal certifies that she/he:

    a. Is the person in the bidder's organization responsible within that organization for the decision as to the prices being offered in the proposal and has not participated (and will not participate) in any action contrary to 1.a., b., and c. above; or

    b. Is not the person in the bidder's organization responsible within that organization for the decision as to the prices being offered in the proposal but has been authorized, in writing, to act as agent for the persons responsible for such decision in certifying that such persons have not participated (and will not participate) in any action contrary to 1.a., b., and c. above.

3. A proposal will not be considered for award if the sense of the statement required in the Cost and Price Analysis portion of the proposal has been altered so as to delete or modify 1.a., c., or 2. above. If 1.b. has been modified or deleted, the proposal will not be considered for award unless the bidder furnishes with the proposal a signed statement which sets forth in detail the circumstances of the disclosure and the Issuing Office determines that such disclosure was not made for the purpose of restricting competition.

I-N CHANGES IN THE RFP

Changes made to the RFP as the result of response made to questions or concerns raised at the prebid meeting (should one be scheduled for this Request; see Paragraph I-E) or through correspondence will be put in writing to each vendor until seven (7) working days prior to date of sealed bid opening. Neither Treasury nor the Office of Purchasing will respond to telephone inquiries or visitation by bidders or their representatives. The Office of Purchasing does not commit to answering questions during the last seven (7) work days prior to sealed bid opening date.

I-O SEALED BID RECEIPT (SEE ALSO PARAGRAPH III-H)

Proposals must be received and time-stamped in the Office of Purchasing on or before the date and time specified on the cover page of the RFP. Bidders are responsible for timely receipt in the Office of Purchasing of their proposal. PROPOSALS WHICH ARE RECEIVED AFTER THE SPECIFIED DUE DATE AND TIME CANNOT BE CONSIDERED.

I-Q DISCLOSURE

All information in a bidder's proposal is subject to disclosure under the provisions of Public Act No. 442 of 1976 known as the "Freedom of Information Act". This act also provides for the complete disclosure of contracts and attachments thereto.

I-R AWARD

The State reserves the right to award by item, part or portion of an item, group of items or total proposal, to reject any and all proposals in whole or in part, and to waive any informality or technical defects if, in the Director of Purchasing's judgment, the best interest of the State will be so served. In determination of awards, the qualification of the bidder, the conformity with the specifications of services to be supplied and the delivery terms will be considered.

I-S CONTRACT PAYMENT SCHEDULE

Payment schedules for any contracts entered into as the result of this RFP will be mutually agreed upon by the State and the contractor. The schedule should show both payment amount and percentage and should reflect actual work done by the payment dates, less any penalty cost charges accrued by those dates. 25 per cent of the total price is to remain for final payment.

I-T ACCOUNTING RECORDS

The contractor will be required to maintain all pertinent financial and accounting records and evidence pertaining to the contract in accordance with generally accepted principles of accounting and other procedures specified by the State of Michigan. Financial and accounting records shall be made available, upon request, to the State of Michigan, its designees, or the Michigan Department of Auditor General at any time during the contract period and any extension thereof, and for three (3) years from expiration date and final payment on the contract or extension thereof.

I-U COST LIABILITY

The State of Michigan assumes no responsibility or liability for costs incurred by the contractor prior to the signing of this agreement. Total liability of the State is limited to the terms and conditions of this agreement.

I-V INDEMNIFICATION

The Contractor shall indemnify and hold harmless the State of Michigan and its agents and employees from and against all claims, damages, losses and expenses including attorneys' fees arising out of or resulting from the performance of the work, which includes all labor, material and equipment required to produce the commodity, construction and/or service required by the Contract (Purchase Order), provided that any such claim, damage, loss or expense (1) is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other that the Work itself) including the loss of use resulting therefrom, and (2) is caused in whole or in part by any negligent act or omission of the Contractor, any Subcontractor, anyone directly or indirectly employed by any of them or anyone for whose acts any of them may be liable, regardless of whether or not it is caused in part by a party indemnified hereunder.

In any and all claims against the State of Michigan or any of its agents or employees by any employee of the Contractor, any Subcontractor, anyone directly or indirectly employed by any of them or anyone for whose acts any of them may be liable, regardless of whether or not it is caused in part by a party indemnified hereunder.

In any and all claims against the State of Michigan or any of its agents or employees by any employee of the Contractor, any Subcontractor, anyone directly or indirectly employed by any of them or anyone for whose acts any of them may be liable, the inemnification obligation under this Indemnification agreement shall not be limited in any way by any limitation on the amount or type of damages, compensation or benefits payable by or for the Contractor or any Subcontractor under Workmen's Compensation acts, disability benefit acts or other employee benefit acts.

The obligations of the Contractor under this Indemnification agreement shall not extend to the liability of the State of Michigan, its agents or employees arising out of (1) the preparation or approval of maps, drawings, opinions, reports, surveys, Change Orders, designs or specifications, or (2) the giving of or the failure to give directions or instructions by the State of Michigan, its agents or employees provided such giving or failure to give is the primary cause of the injury or damage.

I-W CONTRACTOR'S LIABILITY INSURANCE

The Contractor shall purchase and maintain such insurance as will protect him from claims set forth below which may arise out of or result from the Contractor's operations under the Contract (Purchase Order), whether such operations be by himself or by any Subcontractor or by anyone directly or indirectly employed by any of them, or by anyone for whose acts any of them may be liable:

NOTE: This article appears in the current (August 1982) issue of VETERINARY ECONOMICS. If you need more information, please feel free to contact me. HWK

FACE-TO-FACE WITH TAX-EXEMPT VETERINARY FACILITIES

a situation report from the field

Harold W. Knirk, DVM,
Executive Director
Michigan VMA
Suite 11, Manly Miles Building
1405 South Harrison Road
East Lansing, MI 48823

The whole issue of government-subsidized veterinary services is being defined by our profession. It is not a new problem, but one that has become much more widespread. With the economic conditions worsening, our profession can no longer tolerate this encroachment.

Michigan has both tax-supported and tax-exempt groups providing veterinary services. For example, one county health department is supplying veterinary services for persons regardless of their financial need. The county tried to justify it as protection of human health. Our profession challenged this in court, lost the case, appealed the decision, and lost again in the Court of Appeals. The case is being appealed to the Michigan Supreme Court.

Several humane societies also provide subsidized veterinary services without regard to financial need. One of these was challenged in court for violation of its charter and other illegal activities. Three years later, an out-of-court settlement required it to stop its illegal activities.

Simultaneously, a challenge of that humane society's tax-exempt status was made to the IRS. This, too, took three years but resulted in the society's loss of its tax-exemption. A position paper from IRS explained why the society's tax-exempt status was revoked. The IRS position should prove to be a significant event as our profession resolves the overall problem of government-subsidized veterinary services.

Much has been written about court cases involving Michigan veterinarians regarding government-subsidized veterinary services. A Virginia lawsuit also has been well publicized. Both of these efforts achieved a measure of success. Each set a precedent that may be valuable deterrents to future challenges of the free-enterprise veterinary profession we have known in the past.

It is evident, from legal cases thus far, that each situation must be considered separately with regard to state laws, the issues involved, and the willingness of the parties to discuss rationally their mutual concerns and differences. We must strive to dissolve our adversary position and encourage cooperation. We must convince the public we are not uncaring, inhumane, mercenary people as portrayed by many humane societies. Animal owners are interested in saving money. We cannot expect them to show much concern for the veterinarians' position regarding unfair competition. Somehow our posture in this struggle must be kept as a positive force for public and professional good.

Using the position adopted by the IRS, we must work to get national legislation passed and implemented. If we are unable to accomplish this, we will find ourselves defending our position in each community where tax-exempt and tax-supported veterinary services become available. Legal confrontations are very costly to both sides and the animals we all strive to aid will suffer. The best way to assure compliance with the IRS ruling is to have national legislation ensure that tax-exempt facilities will not provide veterinary services without risking loss of their exempt status.

The AVMA has formed a committee to advise its executive board on how it can provide leadership in handling problems of this nature. This committee is exploring the options available to AVMA to facilitate a satisfactory resolution of the conflict between the free-enterprising veterinarians and the providers of government-subsidized veterinary services. This committee, of which I am chairman, has held only one meeting thus far. We examined our challenge and established some preliminary criteria to be used by the executive board in assessing requests for assistance. Conclusions will be submitted after a thorough study of what we already have accomplished, our current position, and our options.

M V A
MACOMB VETERINARY ASSOCIATES
48024 Van Dyke Avenue • Utica, Michigan 48087 • (313) 731-2600

October 27, 1985
The Detroit News
Letters to the Editor
615 Lafayette Blvd.
Detroit, MI 48231

The Detroit News article (10/27/85 p.A3 Hos[illegible]ls sell more than health care today) describing hospitals entering into various for-profit "enterprises" including arrogant quotations from a non-entrepreneur hospital food preparer "we can compete with any caterer in town" should alarm your readers.

This tax-exempt versus small business problem has been steamrolling across this country accelerating to the point where, instead of Socialism instituted by the voters, we are sanctioning Socialism by tax-exempt and tax-favored organizations. Using 1950 legislation set up to give tax relief to certain charities (The Salvation Army and The American Red Cross) an endless list of tax-exempts have prostituted their charters and non-profit status for fun and profit. This archaic legislation is best described by the Small Business Administration as "vague and ambiguous." Tax-favored organizations justify the fantastic costs to the public with some vague "Robin Hood" story-robbing the taxpayers and small businesses to fund a variety of special interests and often exorbitant staff salaries.

These organizations often turn emotional issues against those who claim foul. As chairman of The Michigan Veterinary Medical Associations' Pro-Free Enterprise committee we have attempted to introduce legislation limiting certain humane societies from diverting fantastic assets to build mammoth competing veterinary hospitals in affluent areas, which duplicate and displace existing private practices and practitioners. Even though this is a small business issue, legislators are reluctant to introduce any legislation that may risk being attacked as anti-humane.

As pointed out in the article no small business (and later maybe even big business) is exempt from the non-profits' greed. Catering, printing, gas stations, delicatessen, dry cleaning, real estate, hearing aids, shopping mall landlords, travel agencies, computer sales, managerial services, hot dogs, pizza, and savings and loan business represent only a sampling of the national problem. Some day the public will realize who is really paying the bill; not only the immediate dollar loss, but also the loss of valuable small business owners driven out or prevented from participating in a system no longer best described as "free enterprise."

Alan Berger, DVM

Macomb Veterinary Associates,
Utica

STERLING HEIGHTS VETERINARY CLINIC
VAN DYKE VETERINARY CLINIC • UTICA

(1) Claims under workmen's compensation, disability benefit and other similar employee benefit act. A non-resident Contractor shall have insurance for benefits payable under Michigan's Workmen's Compensation Law for any employee resident of and hired in Michigan; and as respects any other employee protected by workmen's compensation laws of any other state the Contractor shall have insurance or participate in a mandatory state fund to cover the benefits payable to any such employee.

(2) Claims for damages because of bodily injury, occupational sickness or disease, or death of his employees.

(3) Claims for damages because of bodily injury, sickness or disease, or death of any person other than his employees, subject to limits of liability of not less than $300,000 each occurrence and, when applicable $300,000 annual aggregate, for non-automobile hazards and as required by law for automobile hazards.

(4) Claims for damages because of injury to or destruction of tangible property, including loss of use resulting therefrom, subject to a limit of liability of not less than $50,000 each occurrence for non-automobile hazards and as required by law for automobile hazards.

(5) Insurance for Subparagraphs (3) and (4) non-automobile hazards on a combined single limit of liability basis shall not be less than $300,000 each occurrence and when applicable, $300,000 annual aggregate.

The insurance shall be written for not less than any limits of liability herein specified or required by law, whicheveer is greater, and shall include contractual liability insurance as applicable to the Contractor's obligations under the Indemnification clause of the Contract (Purchase Order).

BEFORE STARTING WORK THE CONTRACTOR MUST FURNISH TO THE DIRECTOR OF THE OFFICE OF PURCHASING, CERTIFICATE(S) OF INSURANCE VERIFYING LIABILITY COVERAGE. THE CONTRACT OR PURCHASE ORDER NO. MUST BE SHOWN ON THE CERTIFICATE OF INSURANCE TO ASSURE CORRECT FILING. These Certificates shall contain a provision that coverages afforded under the policies will not be cancelled until at least fifteen days prior written notice bearing the Contract No. or Purchase Order No. has been given to the Director of Purchasing.

I-X CANCELLATION

CANCELLATION OF CONTRACT by the State may be for a) default by the contractor or b) lack of further need for the service or commodity at the location named in the contract. Default is defined as the failure of the contractor to fulfill the obligations of his quotation, contract, or purchase order. In case of default by the contractor, the State may cancel the contract or purchase order immediately and procure the articles or services from other sources and hold the contractor responsible for any excess costs occasioned thereby. In the event the State no longer needs the service or commodity specified in the contract or purchase order due to program changes, changes in laws, rules or regulations, relocation of offices, or lack of funding, the State may cancel the contract or purchase order by giving the contractor written notice of such cancellation 30 days prior to the date of cancellation.

SECTION II
WORK STATEMENT

II-A PROBLEM STATEMENT

The Department of Treasury must educate the public about changes in the individual income tax forms system for 1985 returns. It is also necessary to make the public aware of the taxpayer services available from the Department of Treasury. The Department has determined that television and radio are the best media for this education process. Therefore, the Department is in need of service of a production company which can provide the equipment, personnel and knowledge needed to complete the technical aspects of producing public service announcements. Further, the Department needs the services of creative professionals experienced in this type of work to insure that the product fulfills the Department's objectives.

These announcements must be available for distribution to broadcast stations by November 25, 1985 (45 video cassettes for TV, 320 cassette tapes for Radio).

II-B OBJECTIVES

General:

Produce public service announcements which will convey to the public information about changes in the income tax forms system and about available taxpayer services.

Specific:

Produce four public service announcements as follows:

1. Announce that forms will be mailed.
2. Announce combination of 3 claim forms into one claim form.
3. Publicize toll-free assistance number.
4. Publicize help available at district offices.

II-C TASKS

The following is a preliminary analysis of the major tasks involved for developing the end product of this project. The contractor is not, however, constrained from supplementing this listing with additional steps, subtasks or elements deemed necessary to permit the development of alternative approaches or the application of proprietary analytical techniques.

Responsibilities

The successful vendor will be responsible for the following:

1. Providing considerable guidance and advice on both the audio and video portions of the PSA's. Vendor must be able to begin with a storyboard from the Department of Treasury and offer advice to ensure a provessional, high quality result. The Department of Treasury expects the production company to provide creative assistance in addition to technical service.

2. Assisting the Department in securing talent to appear in the PSA's. The company must arrange for auditions, guarantee that the actors hired will perform their duties and pay the performers. The bid should include the costs associated with hiring talent.

3. Providing all technical services necessary, including but not limited to, photography, sound recording, editing, special effects and copying of announcements for distribution to the media.

The Department of Treasury will:

1. Have a representative on hand for all filming and recording sessions. This work must be done within 100 miles of Lansing.

2. Have final authority to choose talent and make script and video decisions.

3. Distribute the finished PSA's to the media.

II-D PROJECT CONTROL AND REPORTS

1. Project Control

a. The contractor will carry out this project under the direction and control of the Michigan Department of Treasury.

b. Although there will be continuous liaison with the contractor team, the client agency's project director will meet weekly, as a minimum, with the contractor's project manager for the purpose of reviewing progress and providing necessary guidance to the contractor in solving problems which arise.

c. The contractor will submit brief written biweekly summaries of progress which outline the work accomplished during the reporting period; work to be accomplished during the subsequent reporting period; problems, real or anticipated, which should be brought to the attention of the client agency's project director; and notification of any significant deviation from previously agreed-upon work plans.

d. Within five (5) working days of the award of the contract, the contractor will submit to the client agency's project director for approval a work plan which includes the following:

   (1) The contractor's project organizational structure.

   (2) The names and title of personnel the contractor has assigned to the project.

   (3) The time-phased plan showing each event, task, and decision point in your work plan.

SECTION III
INFORMATION REQUIRED FROM BIDDERS

Bidder's proposal must be submitted in the format outlined below. There should be no attachments, enclosures, or exhibits other than those considered by the vendor to be essential to a complete understanding of the proposal submitted. Each section of the proposal must be clearly identified with appropriate headings:

III-A BUSINESS ORGANIZATION

State the full name and address of your organization and, if applicable, the branch office or other subordinate element that will perform, or assist in performing, the work hereunder. Indicate whether it operates as an individual, partnership, or corporation; if as a corporation, include the state in which it is incorporated. If appropriate, state whether it is licensed to operate in the State of Michigan. List all subcontractors, include firm name and address, contact person, complete description of work to be subcontracted. Include descriptive information concerning subcontractor's organization and abilities.

III-B STATEMENT OF THE PROBLEM

State in succinct terms your understanding of the problem(s) presented by this RFP.

III-C MANAGEMENT SUMMARY

1. Narrative

Include a narrative summary description of the proposed effort and of the product(s) that will be delivered. If any support must be provided by a subcontractor, said subcontractors must indicate their capability and willingness to carry out the work. In addition, the information requested in III-A above, and III-E below, must be provided for each potential subcontractor.

JONES VISION CENTER

4218 W. Saginaw
Lansing, MI 48917
Tel: 321-1607

962 Trowbridge Rd.
East Lansing, MI 48823
Tel: 332-2233

May 24, 1987

TO WHOM IT MAY CONCERN:

In April of 1985 Olin Health Center of Michigan State University opened an Optometric Clinic to fit contact lenses. Olin provides health services to Michigan State University students and spouses. It is supported by fees from the students and indirectly by the public's taxes, and as it pays no rent to Michigan State University and very low fees for Janitor and utility services.

This contact lens service was not needed. Contact lens services were adequately provided for by local Doctors. Also Contact lenses are for predominantly cosmetic reasons, not health reasons. It seems that Olin had approximately $70,000.00 they didn't know what to do with and so decided to open an Optometric Clinic.

Olin's Optometric Clinic fees are about 25 to 35% less than local private Optometrists. My East Lansing office, which is across from the campus, suffered a 50% drop in Contact lens patients after the clinic opened. I asked Olin to at least charge prevailing fees,such as their dentist, the Veterinary clinic and Clinical center do, but they refused. I had a lot of correspondence with the clinic and with Jack Breslin with no results. The presidents' office did'nt even know the clinic was being opened, and the Clinic received no input from either the State or local Optometric Associations and have never explained why it was decided to open the clinic. This is another instance of unfair competition by a non tax paying institution. I contributed a great deal of money for four of my children to attend M.S.U.. Now I find that the fees went toward paying for M.S.U. thru Olin Optometric Clinic to be in competition with me. As was noted in the State Journal, Michigan State University is not a focal point for business growth as so many other Universities are.

Sincerely,

Ronald C. Jones, O.D.

Ronald C. Jones O.D.

Open 365 days

11 a.m. to 11 p.m.

Conveniently located on south MSU campus, 138 Service Road, between Farm Lane and Hagadorn Roads.

Free transportation provided evenings and weekends, if needed in the immediate area.

Call 353-9790 for this service or for more information about our facility.

*However, for severe conditions such as suspected heart attacks or other life threatening situations, please call an ambulance for transportation to a hospital.

The MSU Minor Emergency Clinic is affiliated with the MSU College of Human Medicine and is not part of the Olin Health Center Services.

MSU is an affirmative-action, equal-opportunity institution.

MSU CLINIC

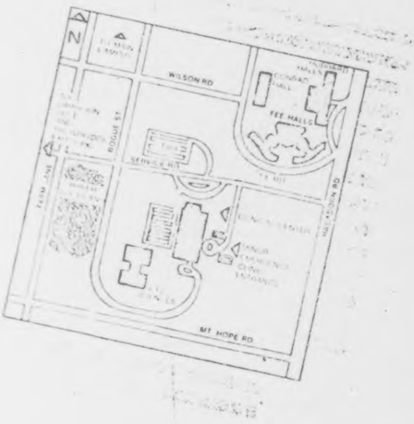
A NEW ADDITION TO THE MSU CLINICAL CENTER SERVICES

Quality medical care is provided for your minor illnesses and injuries by skilled emergency physicians.

No appointments are needed.

Prompt attention **at less than half the cost** of most hospital emergency departments.

A sample of the medical emergencies handled includes burns, fever, flu, fractures, allergies, abdominal pain, bronchitis, colds, cuts and lacerations, job-related injuries, nosebleeds, skin rashes, sore throats, foreign objects in the eyes, sprains, and urinary tract infections.



Letters to the Editor . . . .

Dear Editor:

Great job on the NEWSLETTER! Both format and content are worthwhile. This letter concerns your "Editor's Message" section.

Since I am both a businessman and taxpayer, I have rather strong feelings about tax-exempt organizations selling products and services. On the plus side, these institutions may serve a population of patients that are unwelcome in the for-profit private sector (i.e., the indigent patient.)

On the other side, my taxes are being used to underwrite part of the expenses generated by my competition. Frankly, I don't think you can have it both ways.

Having been in the situation, I think it is critical that university settings operate dispensing operations. This is probably the only way that a student can get a realistic flavor of the real world of private practice. What I object to is the active marketing of hearing health care services to the public, stressing the lower cost of the service in the tax-exempt setting. Conversley, such advertising has usually benefitted us directly by making the public more aware of hearing problems.

Those of us who have been in private practice for any length of time have nothing to fear from such competition. However, I would feel very differently if I were just starting out. It boils down to a matter of principle, and a need for those of us in the private practice community to be willing to service all types of patients, knowing that we will sometime take a financial bath.

Considering the present makeup of the membership of ADA, I would be surprised if you had an avalanche of interest in the issue. Sad, because it does affect the development of free-standing private practice. Keep up the good work.

Kenneth E. Smith, Ph.D.
Hearing Associates, Inc.

Dear Editor:

I read with interest the article from the Grand Rapids Press regarding the controversy of the "not for profit" Northwest Hospital's Hearing Center vs the retail hearing aid center in Seattle. I was dismayed by Mr. Maher's comments as, in my opinion, they reflect old time ASHA dogma and fail to consider the real issue. Mr. Maher fails to realize that his public service announcement was in fact advertising for free hearing tests which reduces the capability of the hearing aid retailer or the audiologist (dispensing or not) from making money on the service of testing hearing. Without question, Mr. Maher and his staff have used the "Free Hearing Test" as a lead which ultimately resulted in the sale of a hearing aid to a portion of those individuals who responded. Since I'm sure Mr. Maher has fit hearing aids to these individuals, I'm also sure that he, his staff, and the hospital benefitted from that sale. The amount of the benefit is not an issue. He is free to set his prices at whatever he chooses, but the fact that the provider of services derived benefit means that they in some way profitted from the exchange. So technically, the "not for profit" organization got profit - be it added revenues (private, foundation, federal or state money), positive public relations (from offering more comprehensive community service as well as having the name Northwest Hospital repeated time and again), an additional quantity discount on other purchases, and a source of referral leads for future business. So in my opinion, Mr. Maher and Northwest Hospital have indeed profitted. To throw in the ASHA dogma that the retailer has only a profit motive while the illustrious white knighted university audiologist has only pure gold motives is truly a shame. Over my sixteen years as an audiologist, I've met many hearing aid retailers who are sincerely interested in providing quality hearing health care. I've also met many audiologists who provide shoddy hearing health care, but who hide behind the shield of a CCC-A to question the motivation of the retailer. What garbage!

Mr. Maher and other such "not for profit" organizations have the same motivation as those in private practice and in retail hearing aid offices. That is, to provide a service which will generate a satisfactory living for all the employees. To hide behind the "not for profit" cloak and to throw in the issue of motivation and training in a basic business activity is ridiculous. I am dismayed that the ADA actually has members who question the fact that one can provide a good service and earn a profit from that service. Mr. Maher implies that he is virtuous while the retailer is not. In so doing, he implies that all of us who sell hearing aids are less than virtuous. I strongly disagree and take umbrage to his implication. I recall that Mr. Maher is a pilot and owns his own plane. How did he pay for that if he provides only services to the indigent and does so at no profit. To borrow from Charles Van Riper - call a spade a spade! Northwest Hospital, John Maher and other "not for profits" are taking advantage of the system and are self righteously deprocating the people who pay for these "not for profit" bills) i.e. the taxpayer.) That's you and me folks! I do not deny them the opportunity to make a profit, but they should be required to do it on the same basis as the rest of the world. In this case, it means paying for their advertising.

Sincerely,
Richard Navarro, Ph.D.
Audiologist, CCC-A, F.A.D.A.

Profit vs. Non-Profit The Debate Continues

The following is a copy of a letter to the President of the University of Arizona.

Subject: Intention of University of Arizona Hearing Clinic to sell hearing aids.

Dear President Koffler, 11-7-86

On Wednesday, October 29, 1986, I was told by a prospective client that your hearing clinic has decided to start selling hearing aids. This was quite a surprise to me, since there had never been any indication from the University that it thought the present dispensing system was inadequate. In fact, there is actually evidence to the contrary.

I immediately arranged a meeting with Dr. William Hodgson on Friday, October 31, 1986. In our conversation, Dr. Hodgson confirmed that the Clinic did indeed intend to start selling hearing aids to the general public in January

continued on page 10 —

continued from page 3 —

of 1987. He indicated that he thought it would be a valuable educational experience for his students. The Arizona Hearing Aid Society most vigorously disagrees. This move by the University must be seen for what it is. Another unjustified encroachment into the private section by a public institution bent on increasing its revenues at the expense of the taxpayers who support it.

Detailed below are the reasons why we think this activity is not justified:

1.) The University Clinic presently offers hearing tests through its students to the public for the purpose of training these students in the art of Human Hearing Testing. When these people are in need of hearing assistance (hearing aids) the students then conduct tests which are supposed to indicate the unit(s) which will best correct a person's hearing deficiency. They then recommend that the person purchase the indicated unit(s) from a local hearing aid office on a trial basis.

The person returns to the clinic with the hearing aid(s) to have them fitted and adjusted. The person is also provided with the initial counseling which is an integral part of hearing aid fitting and sales.

The only part of the sales process which the University student is not presently conducting is the filling out of a purchase order and sending it to a hearing aid manufacturer. I fail to see how this could be considered a "valuable educational or research experience." It is only by virtue of such experience as defined in the "non-competition with free enterprise law" that the University would be able to justify the sale of hearing aids.

It may be stated by the University that the mode of hearing aid fitting is changing, necessitating it to teach "All-In-The-Ear" fitting techniques. With this we fully agree, since the University's current methodology seems to be fatally flawed. But, this still does not require any changes in the current delivery system, but only in the testing/evaluation procedures.

2.) Dr. Hodgson indicated that the department endeavors to teach a total of ten graduate students in any given year. Now given the possibility of each student selling one hearing aid or more per week, the University could easily be selling 40 units per month. This is a sales volume greater than that realized by over 60% of the private sector hearing aid offices. With the initiation of this process the University could easily reduce by 10-15% the total number of hearing aids sold by the private sector in Southern Arizona. This would more than likely cause some offices to close; thereby, limiting services to the general public, most of whom are elderly. This could also cause these people to go without many routine services provided by their local hearing aid offices. It could result in an increase in price by many offices, as a way of staying in business. This certainly does not seem like the kind of community service image the University likes to project.

3.) Once a person has been fitted with a hearing aid, hearing becomes very important. As a retail sales location, the University must be expected to provide all normal warranty service, as well as the cleaning and adjusting of hearing

continued on page 11 —

MAICO

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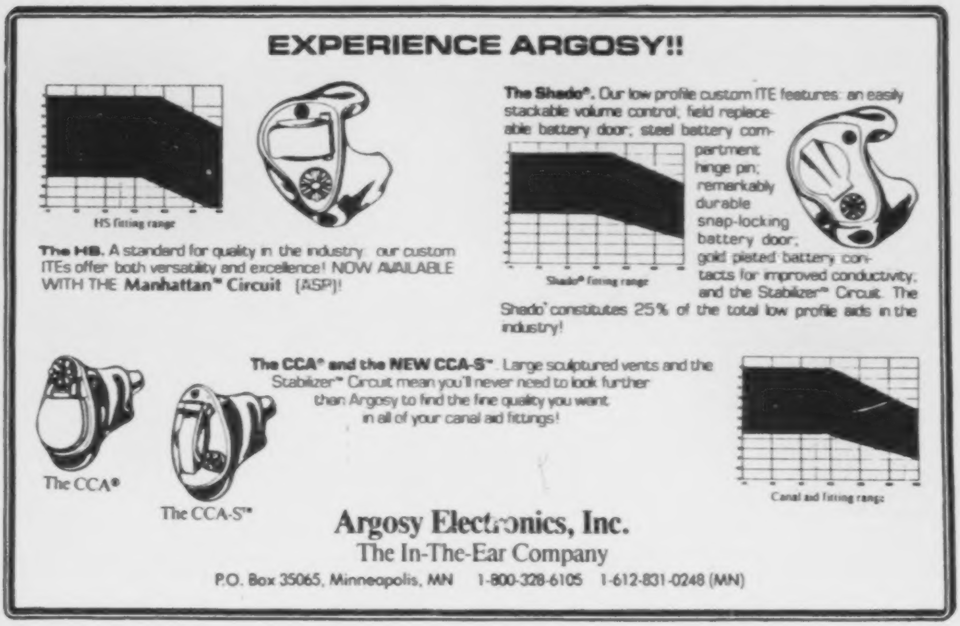

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continued from page 10 —

aids. Is it reasonable to expect these needs to only occur during those times when the clinic is open and fully staffed?

Local hearing aid offices cannot be expected to provide free service to University clients. This would require the clinic to have full staffing during the mid-term break and the summer months. It will, in all likelyhood, require the extension of contracts with audiologists, who are presently employed by the University in the private sector. To do otherwise would be to break faith with those the University is supposedly helping.

Provision of these services by the University, as a teaching institution, must be done under the direct supervision of faculty. To do otherwise could easily expose the University to lawsuits, not to mention possible violation of state law. The need for a larger clinic staff again could easily be the result of this process. this thereby fulfills the duty of government employees to create a larger bureaucracy irregardless of public need.

4.) Again, in my conversation with Dr. Hodgson it was mentioned that no one currently employed at the University of Arizona Hearing Clinic has ever sold a hearing aid. Indeed prior to 1977 the American Speech, Hearing and Languages Association did not allow its members to sell "FOR PROFIT." The world of course changes, but if selling is something the Hearing Clinic students need to learn, we believe they would be better served by taking sales and marketing courses given by professionals in the field.

It may however be argued that the students have already in essence been selling hearing aids. They have been counseling (selling) people on the need for hearing aids for many years. It is; however, impossible to simulate, in a University environment, the interaction between a potential hearing aid wearer and the hearing health professional because of the unquestioning reverence of the public for any position espoused by the University.

5.) The University of Arizona Hearing Clinic conducts all tests by appointment. People often have to wait six weeks or more for appointments. So, it would seem there is no lack of hearing impaired people for the students to practice on. Many of these people have insufficient income to purchase any type of hearing aid; therefore, the University dispenses used or reconditioned hearing aids collected by various non-profit organizations. This is the type of public service that a University should properly furnish.

Given the already full testing schedule at the Hearing Clinic it seems abundantly clear that the University will be forced to reduce its services to the indigent population of Southern Arizona in an effort to accomodate the more affluent who can afford to purchase hearing aids. Indeed, the hearing and speech department has asked for permission to advertise the fact that they sell hearing aids in the "yellow pages." Does this not sound like unfair competition? And to what purpose?

In a similar context the University Medical Center has neatly sidestepped provisions in state law prohibiting the sale of prosthetics. Leasing its Ear, Nose and Throat Clinic

continued on page 13 —

continued from page 11 —

to a private Entity could be legal, but is it what the Legislature had in mind when it created the University Medical Center. And, since Speech and Hearing Department faculty have staff rights at the University Medical Center, they could use that environment as a sales location if they should so choose.

With the choice of testing the indigent population or the affluent who will add funds to the hearing and speech department, who do you think will be given priority? Once again, this added demand will probably be used as a reason to justify the need for increasing the size of the Hearing Clinic.

6.) The University Hearing Clinic is presently using new hearing aids loaned to it by various manufacturers. These aids are used to evaluate the potential improvement in hearing, which may be achieved for the hearing impaired.

When the clinic begins to sell hearing aids it will no longer be considered a teaching and research institution by these manufacturers. The clinic will be forced to purchase all of these instruments or return them to the manufacturers. It is the stated position of all major U.S. and foreign hearing aid manufacturers that they cannot discriminate against normal hearing aid sales offices by supplying free hearing instruments to public institutions which sell.

As state taxpayers we must question the fiscal responsibility of an institution which intentionally spends money for items which would be willingly provided, at no charge, save for the institution's decision to enter the private market.

7.) Clinical audiologists perform a very valuable function as part of what is termed the "Hearing Health Care Team." National statistics show that universities are now graduating more students than the field can reasonably be expected to employ. So enlarging the department will not be a service to the public, but will be a disservice to the students who will graduate into an already saturated specialty.

With all of the above, I believe I have clearly stated the facts. It is this Societies position that hearing aid sales is not a proper function of the University of Arizona Speech and Hearing Department. We feel that audiology students, and the general public would best be served by:

1.) The University continuing its testing activities as they are currently constituted.

2.) The University continuing to serve the indigent hearing impaired public.

3.) The University entering into a dialogue with hearing aid sales locations in the area with the intent of creating internship opportunities within these facilities. The students would be supervised by competent, licensed professionals, and would get realistic training. They would also have the opportunity to evaluate which segment of the profession would best serve their individual goals prior to graduation.

Your attention to this matter and early response will be appreciated.

Sincerely,
K. Ray Katz BC-H.I.S.
President

Editor's Note: State University programs with dispensing services have long been supported by ASHA. What is the impact of these services on your practice? Feedback.

Starkey
20th
Anniversary

Hearing is Our Concern

DUES SAVER DUES SAVER

I hope to see ALL of you at what is shaping up to be our biggest, best and most exciting Annual Spring Meeting ever!

Your dues saver this month is through the fine work of President-Elect Dave Citron. He made the arrangements for special rates to get to San Diego via United Airlines.

The savings are marvelous. I checked regular coach fare to San Diego from Harrisburg, Philadelphia and Baltimore. Coach fares one way were in the $500 range! Night coach rates were $408 one way! And I plan to be there with my wife. This was expensive.

Then I used the WATTS number in our registration form to get United Airlines special ADA rate. My round-trip was locked at $358 each leaving Harrisburg . . . my closest airport.

And if I had wanted to leave via Baltimore . . . round-trip was $308.00!

If United doesn't serve your airport . . . consider a short hop fight to connect with an airport that does carry United. Or just let United book the flight via your carrier. It will still save you a bundle.

Thank you, David, for your excellent Dues Saver!

Herb McCollom
President

DUES SAVER DUES SAVER

NATIONAL HEARING AID SOCIETY

20361 MIDDLEBELT • LIVONIA, MICHIGAN 48152 • TELEPHONE (313) 478-2610

NATIONAL HEADQUARTERS

Executive Vice President
Anthony DiRocco

December 19, 1986

Dear Member:

For more years than we'd like to remember, your National Hearing Aid Society has been fighting for an end to unfair competition from non-profit organizations. Thanks in large part to the efforts of our NHAS delegation at the 1986 White House Conference on Small Business, the unfair competition issue is finally receiving attention from the Federal government.

The Oversight Subcommittee of the House Ways and Means Committee will hold a hearing on unfair competition from non-profit organizations in 1987. This hearing is a great opportunity, one which must be utilized to the utmost. To succeed, we must have your assistance.

Congress is recessed until January 6th, which means your Representative is likely in your district and available to meet with constituents...like you. To establish the urgency of the unfair competition problem and the importance of the upcoming hearing, we need you to tell your Congressman how your business is being hurt by "commercial" non-profit entities selling hearing aids. If you're not able to meet with your Representative, write a letter expressing your feelings on this issue and please send a copy to NHAS headquarters.

Our headquarters staff is available to help you identify and contact your Congressman. (Please be prepared to give your district number). To help you prepare, we've enclosed a brief factsheet on unfair competition for you to review. Please don't hand this sheet to your Congressman, he wants to know your story...how your business is being effected by unfair competition. If you have any questions on what to say and what not to say, contact our headquarters staff.

A vast array of tax-exempt organizations are now selling hearing aids, in direct and blatantly unfair competition with you...tell your Congressman about it! With your cooperation a solution is within our grasp.

Sincerely,

Tony DiRocco

Anthony DiRocco
Executive Vice President

AD:pw
enc.

med·inn

January, 1987

Dear Medical Center Visitor:

We know that you need to visit the University of Michigan Medical Center on occasion and we also know that finding lodging in Ann Arbor can be difficult. We think we may have solved that problem.

The Med-Inn is a new hotel opening in February. It is located in the center of the medical complex and is connected to the University Hospitals by walkways.

Included in the room rate is free parking and we will also serve a complimentary continental breakfast each morning.

If you need to visit the University of Michigan Medical Center after February 15th, we'd love to have you stay with us at Med-Inn. Please feel free to call for reservations or more information.

Sincerely,

Beth Dugdale

Beth Dugdale
General Manager

BD/0511j

The University of Michigan Medical Center
1500 East Medical Center Drive, Box 0850 Ann Arbor Michigan 48109 313/936-0100 1-800/544-8684

The new hotel in The University of Michigan Medical Center

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MEDICAL CENTER

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Box 0850
Ann Arbor, MI 48109

The University of Michigan Medical Center
1500 East Medical Center Drive, Box 0850
Ann Arbor, Michigan 48109

med·inn

MARTHA A ANDREWS
3435 INVERARY
LANSING MI 48910

Tourism center awaits approval

Michigan tourism, one of the state's top three industries, is fragmented, but a MSU parks and recreational resources professor said he hopes to do something about it.

Don Holecek has helped to organize the proposed MSU Travel, Tourism and Recreation Resource Center, which is awaiting provost approval. The center would offer assistance to Michigan tourism businesses.

"We want to centralize the industry. We want to make a one-stop shop, so to speak, for businesses in the tourism industry," Holecek said.

"If we can help businesses be successful, that brings more business, and that helps better (Michigan's) economy."

The center has the funding it needs but cannot operate under official status yet.

"(This office) will recommend that it be approved," said MSU Vice Provost Jim Anderson. "The center is proposed to serve as clearing house and data base for tourism and recreation.

"It's going through the normal administrative process, which should be done within the next couple of months. It involves a number of departments and the units involved need to look and see if their inputs are considered."

ONE OF THOSE units is the school of business.

Business Dean Richard Lewis said the department received the proposal and HRI acting director Michael Kasavana is heading the review process.

"Right now we're just a series of programs," Holecek said. "We could become a real center at any time."

The programs use undergraduate and graduate students to help gather information, create data bases and make audiovisual presentations.

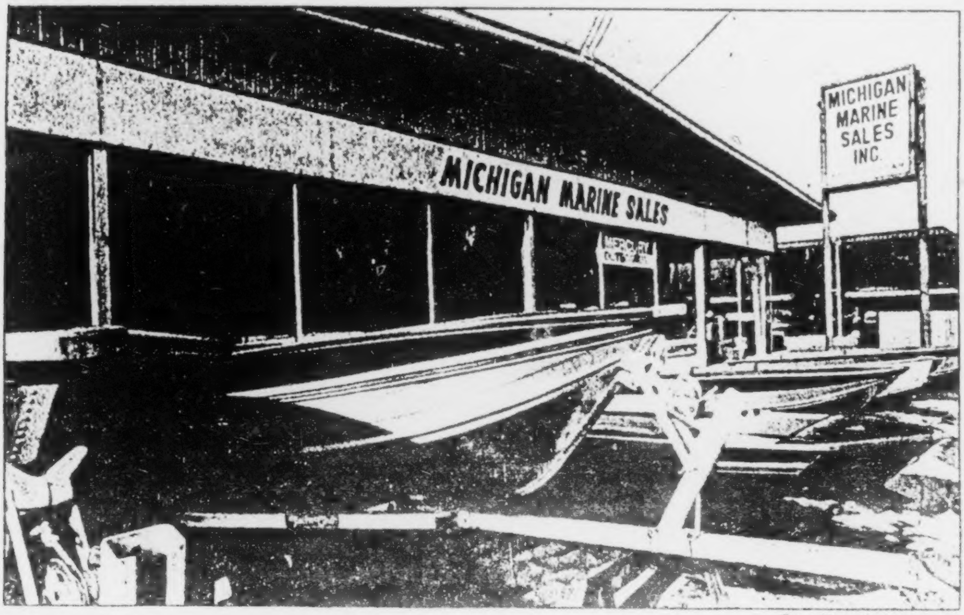
"We employ four or five grad students and eight to 10 undergrads, but we're about at capacity for the year," he said.

The center definitely would benefit the state, Holecek said.

"Tourism is an industry that ranks right with or slightly below agriculture (the state's second largest industry). But in many ways, especially skills and high tech, it is primitive."

The proposed center would assist tourism industries in addressing their central needs, Holecek said. These include promotion; keeping records of who is coming, going and spending money in the state; bringing high tech and better management to the state industry; and planning the future of tourism in Michigan.

ONE OF THE WAYS the programs address these needs is through



State News/Wayne Pope

Recreational boaters spend more than $1 billion in Michigan annually, said Don Holecek, MSU professor of parks and recreational resources. Holecek helped plan the proposed MSU Travel, Tourism and Recreation Resource Center that would be a resource for tourist-related businesses like Michigan Marine Sales Inc., 6936 S. Cedar St., Lansing.

information organization and research.

"In 1981 we started to decide what the industry needed," Holecek said. "We did not want a data center which would essentially be piles of information no one could use. We decided the industry needed an attainable data center. Then we added training and extension services, then research."

The benefit of this system is the availability of information for businesses to use, he said.

"Think of any goods or services someone visiting in the state would buy," he said. "It's basically across the board. We're concerned with lodging, camping, food or where you might keep your boat. We're also concerned with the environmental end of things."

Holecek said Utah is the only other state he knows of with a similar program, but MSU will not pattern the center after the Utah organization.

"Although one-half the tourism dollars in the state are spent in the Detroit area, some places up north earn 70 to 80 percent of their incomes through tourism."

EXAMPLES OF UNIVERSITY COMPETITION WITH PRIVATELY OWNED GOLF COURSES

Michigan State University, University of Michigan and Ferris State have five golf courses that I am aware of. These golf courses accommodate golfers from the general golf market in direct competition with tax paying privately owned golf courses.

If these Universities were only concerned with recreation for their students and faculty, they would sell the golf courses to be used as daily fee courses that would still provide a recreational facility. Those golf courses then would also pay taxes, rather than be indirectly subsidized by the golf courses that pay taxes and lose business to the subsidized Universities.

Robert G. Milosch
Carleton Glen Golf Club

RIVERSEDGE
MARKETING INCORPORATED
900 LONG BOULEVARD, SUITE ONE
LANSING, MI 48910 517/694-7174

Businesses & Associations for a Strong Economy
P.O. Box 20171
Lansing, MI 48901

To whom it may concern:

I was unable to make it to last Friday's meeting, but I do have an item of interest I wanted to share with the folks there. Unfortunately because it had become a "dead" issue I was unable to conjure up the copy of the State of Michigan RFP issued last summer from the Department of Management & Budget.

The project was to develop a marketing plan and promotional strategy to promote Recycling efforts throughout the state and the issuing department was the DNR.

Riversedge Marketing Incorporated did not win the bid, and that in itself was not reason enough for disgruntlement. What was most irritating was that Michigan State University did! The letter stated that the Cooperative Extension Service was the winner as the smoke cleared.

I'm not sure just how much significance this has to the cause, or how much time I can devote to tracking it down. My relationship with the State of Michigan and its RFP process is shaky at best at this point, though I continue to seek work through the channels. It seems to be a system without logic, and a source of extreme frustration and expense to our firm.

If you need additional information please let me know.

Sincerely yours,

Betsy Gerkman

Betsy Gerkman
President

to MARTY ANDREWS

RAILWAY SYSTEMS ENGINEERING CORPORATION

1154 ROSLYN ROAD (GPW)
P.O. BOX 351
ST. CLAIR SHORES, MI 48080

TELEPHONE: 313/884-3777
TWX: 810-221-5125
TLX: 23-0455 & 6877023

13 August 1982

Edmund Perkowski, Contract Administrator
Bureau of Classification
Department of Civil Service
Lewis Cass Building
Lansing, MICHIGAN 48909

cc: Mr. Donald Meyers, Director
Policy Division
Michigan Department of
Civil Service

Subject: Comment regarding revised procedure (Section IV, D) for requesting use of Contractual Personal Service, as approved by the Michigan Civil Service Commission on 28 June 1982

Dear Mr. Perkowski:

The purpose of this letter is to offer our comments regarding the subject identified above. We understand that the Michigan Civil Service Commission will consider our and other organizations' comments at its meeting to be held on 01 September 1982.

Railway Systems Engineering Corporation, a Michigan corporation, strongly supports the addition of Condition "D" to the list of standards for approval of a request for contractual personal services. The prospective cost savings to the State of this new condition are very great.

For example, we are involved in a dialogue with the Michigan State Transportation Commission regarding the costs of performing certain required professional services to assess the feasibility of a prospective high-speed passenger railroad service. Michigan DOT presently plans to contract the work to another State-owned institution, Michigan State University, which in turn plans to subcontract two-thirds of the work to a subsidiary of a government-owned railroad company in Great Britain. Were Michigan DOT to contract with Michigan-based private firms for this work rather than rely on government-related organizations, the State and federal governments stand to achieve cost savings of at least 50 per cent on this project alone.

We enclose the transcript of our 28 July presentation to the Michigan State Transportation Commission to provide elaboration on the example discussed in the preceding paragraph. We applaud the Michigan Civil Service Commission for taking the initiative to add Condition "D" to the list of alternative criteria warranting Civil Service Commission approval of requests to contract with private enterprises for the provision of professional and other personal services required by State agencies.

Sincerely yours,

Dietrich R. Bergmann

Dietrich R. Bergmann
President

Enclosure

DRB/js

RAILWAY SYSTEMS ENGINEERING CORPORATION

RSE T.M

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STATEMENT BY DR. DIETRICH R. BERGMANN, PRESIDENT OF RAILWAY SYSTEMS ENGINEERING CORPORATION, TO THE MICHIGAN TRANSPORTATION COMMISSION ON 28 JULY 1982

Mr. Chairman and Members of the Michigan Transportation Commission, my name is Dietrich R. Bergmann. I am a native of Southeastern Michigan and speak before you today as President of Railway Systems Engineering Corporation, a consulting engineering firm located in Grosse Pointe Woods, Michigan. I am here to voice my firm's objection to the procedure that the Bureau of Urban and Public Transportation (UPTRAN) in the Michigan Department of Transportation (MDOT) is apparently following in awarding a major consulting contract.

At a meeting with a Federal Railroad Administration (FRA) official in Washington during January of this year, I learned that Michigan was to be the recipient of an FRA grant for a high speed rail feasibility study. The purpose of the study is to assess the economic and financial potential for high speed passenger rail service between Detroit and Chicago.

During the following five months I inquired about the project with MDOT/UPTRAN staff and was generally given evasive answers.

During the past several weeks it became apparent to me that the Detroit-Chicago high speed passenger rail service study will be a $350,000 effort that focuses on the right-of-way presently used for Amtrak's Detroit-Chicago passenger rail service. The essential features of the study as they have been described to me by various MDOT, Michigan State University (MSU), and FRA officials are as follows:

Statements by MDOT/UPTRAN Officials

- The Michigan State Transportation Commission has awarded a $100,000 grant to MSU to conduct the study; the grant is conditioned on the receipt by MSU of federal matching funds.
- This is an MSU project. Contact MSU officials for details.

Statements by MSU Official

- The matching share from FRA is approximately $250,000.
- MSU will have a subcontractor for the project, which will be Transmark Worldwide. (Transmark Worldwide is a subsidiary of British Rail, the nationalized and subsidized railroad company and railroad rolling stock manufacturer of Great Britain.)
- The feasibility study proposed to FRA was proposed jointly by MSU and Transmark.
- Although there is not yet a contractual relationship between MSU and Transmark, it is anticipated that approximately two-thirds of the $350,000 budget will be spent by Transmark and that approximately one-third of the $350,000 budget will be spent by MSU.

- o One of Transmark's responsibilities will be to estimate the demand for the Detroit-Chicago high speed passenger rail service. Another will be to evaluate "supply side" issues.
- o Two Transmark employees from London (England) already have arrived in East Lansing and are working out of MSU offices. Approximately two Transmark employees will continue to be at MSU during the tenure of the study, which could run for 11 or 12 months after it formally begins.

Statements by FRA Official on 26 July 1982

- o The $250,000 grant award is being made on the basis of a work statement received by FRA from Michigan DOT during November 1981.
- o FRA's negotiations regarding the award of the $250,000 grant have been primarily with MDOT.
- o The FRA grant will be made to MSU directly, but only if Michigan DOT formally advises FRA that MSU can receive the grant as Michigan DOT's agent, assignee, or designee.

Gentlemen, although there are some inconsistencies among the statements that have been made to us, it is clear that the procurement procedure for this project is very unusual. My firm objects to it, for the reason that it denies qualified Michigan and other United States consultants to compete for the effort.

There are two other factors that tend toraise questions regarding this procurement--

- o First, the timing seems unpropitious, inasmuch as I have been told by MDOT staff that they can not come up with $2,400,000 to purchase a rail line that will reduce the Detroit-Chicago high speed passenger rail service implementation cost. This funding problem seems to be incongruous with the fact that MDOT has been able to expend sufficient staff resoures to pull together funds for a $350,000 consulting contract.
- o Second, although we have not seen the detailed work statement that was submitted to FRA for the Detroit-Chicago project, what I have been told by MDOT and MSU officials leads me to suspect that the effort is overbudgeted by as much as 100 to 125%. The basis for this tentative conclusion is as follows:
    - (a) The costs of upgrading the Detroit-Kalamazoo segment of the Detroit-Chicago line for high speed passenger rail travel have already been estimated by my firm as a subcontractor to General Motors on a MDOT/UPTRAN-sponsored project now being concluded to assess the feasibility of low-speed and high-speed passenger rail services between Detroit and Grand Rapids. Kalamazoo is the mid-point of the Detroit-Chicago route.
    - (b) The costs of upgrading the segment between Kalamazoo and Michigan City (Indiana) to 79 mph already are known to Amtrak, inasmuch as they already are upgrading that line. The costs of further upgrading to permit even higher speeds should be readily available to Amtrak and MDOT staff.

STATEMENT BY DR. DIETRICH R. BERGMANN, PRESIDENT OF RAILWAY SYSTEMS ENGINEERING CORPORATION, TO THE MICHIGAN TRANSPORTATION COMMISSION ON 28 JULY 1982
(page 3 of 3)

(c) Patronage analysis for the Detroit-Chicago route was completed for MDOT by Transmark in a contract that cost the State approximately $130,000. The original MDOT budget for that work at the time requests for proposals were issued was $100,000. I know of at least one competent United States firm that offered to complete the work at a price equal to the budgeted amount.

(d) One type of revenue-producing business that could be attracted by a high speed Detroit-Chicago passenger rail service is the transport of mail on passenger trains. The revenue-generation capability for this business is to be considered in the MDOT project. However, the market for Detroit-Chicago mail transport already has been estimated in a report done by my firm at no cost to either General Motors or MDOT at the same time we completed a review of the Detroit-Lansing-Grand Rapids mail transport market as a part of the Detroit-Grand Rapids passenger rail service feasibility study.

Gentlemen, please don't misunderstand me. We support railroad transportation. We also support a concerted effort by MDOT for the development of high speed passenger rail service between Detroit and Chicago. However, we also support a businesslike approach to achieving these goals. Consequently we insist that you suspend the ongoing procurement process for this project and that you direct MDOT staff to announce a competitive procurement. Inasmuch as UPTRAN management already has shown its preference for the consultant to be chosen, we ask that the Commission itself select neutral, but technically qualified, referees to lead the review of consultant proposals as well as the consultant selection. We also ask that those referees be given certain consultant selection criteria that are to be determined by the Commission following a public hearing and that are to be publicly announced at the time requests for proposals are disseminated.

If you follow the steps we are recommending, you will find that the private sector ingenuity and initiative that made this state a great state is still here and that your requirements can be met both proficiently and at a cost that the Michigan and United States Treasurers and all taxpayers will appreciate.

Gentlemen, my firm -- and I am sure other Michigan consulting firms -- are asking you to do nothing more and nothing less than to give yourselves an opportunity to SAY YES TO MICHIGAN.

erinarians form their own · society and operate under ›rofit status themselves ·erving indigent clients. ight wipe-out animal con- the humane societies' rea- existence."

:rinarians and humane so- hould cooperate in publiciz- nal care," stresses William s, executive director of the ·y County Society for the ıon of Cruelty to Animals ›rnia.

·rfect opportunity for this :ion could begin with the ' nimal Bond Movement noted by humane societ- ıthers continues. "Humane : could supply the animals, .rians could care for them. l and care costs could be ›y both.

ther area of cooperative en- might be to educate the ın the importahce of pet l neuter. Humane societies erinarians could jointly ·ite a massive Madison ›ublicity campaign convey- ıdea that *Real Men Have l Dogs*," says Brothers.

suggestion brought a ' applause. When the con- :losed, most veterinarians ouraged that resolution, not easy, was possible.

he verbal agreement and ıetic camaraderie at the of the conference are far ›m equitable settlements. '·rinarians have traveled oefore and found them- ı a treadmill. So, who will › on the proposals and see

GROSS INCOME FELL FROM $200,000 to $60,000

Eighteen years ago, Dr. Nicholas Szluha opened his veterinary practice in Auburn Heights, Mich., an affluent neighborhood in the county of Oakland, township of Avon. Oakland is Michigan's richest county, and Avon Township, population 40,626, boasts a median family income of $31,830, according to the 1980 census.

Because of these positive economic indications, Dr. Szluha, then 35, had expected his practice investment in Avon Township to afford him a comfortable and prosperous livelihood.

Then, without warning, disaster struck. In 1979, when Dr. Szluha's practice was grossing $200,000, he decided to expand and remodel his facility. He applied to Avon Township authorities for proper permits, only to be rebuked for seemingly innocuous reasons: His floorplans weren't professional and up-to-date; his parking lot was too small. After enlisting the services of an architect and investing more than $5,000 to comply with the township's building codes, he resubmitted his plans for approval.

Again he was stopped. This time, the township said that building, or even expanding, a veterinary hospital in his neighborhood would violate Avon zoning laws. Dr. Szluha abandoned his hopes for a larger clinic.

In January 1980, however, only a few months after Dr. Szluha was denied his building permit, Avon authorities approved construction of a million-dollar, full-service veterinary clinic. That clinic was proposed by the Michigan Humane Society. The proposed site of the society's clinic? Directly across the street from Dr. Szluha's practice.

In desperation, Dr. Szluha challenged the township's actions in court. On three separate occasions and after pouring more than $20,000 from his personal savings into his cause, efforts to block the invasion of the humane society ended in vain.

"When the humane society's facility opened for business last March, not one client walked through my front door for three solid weeks," Dr. Szluha laments. "Not until we dropped our prices to a 1965 level, well below what the Michigan Humane Society charges for its services, did we begin to see clients again. I expect my annual gross to drop below $60,000 this year.

"I'm going to appeal the zoning decision, even if I have to fight it all the way to the Supreme Court," Dr. Szluha vows. "I'm 53 years old. The only thing I have left is my practice. I'm too young to retire, too old to start over somewhere else. I've been here for 18 years and this is where I want to stay."

Amid the legal fracus, Dr. Szluha appealed to the American Veterinary Medical Association (AVMA) and other associations for help, but to no avail. "The AVMA people told me they were organizing a committee to study the problem," he explains. "I told them I didn't think I could wait that long."

UNFAIR COMPETITION IN VETERINARY SERVICES

Peter A. Prescott, DVM
Executive Director
Michigan Veterinary Medical Association

Michigan's recent White House Conference on Small Business identified "unfair competition by nonprofits" as one of its major concerns to be taken to Washington for the August 1986 National Conference. For an introduction to this complex issue, the Small Business Administration in Washington has published a 50-page report, Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s, on this subject. Now in its third edition, the report includes veterinary services among the growing list of businesses faced with competing with tax-exempt or tax-supported organizations.

Originally nonprofit animal welfare organizations provided veterinary services limited to strays or animals owned by indigents. In an attempt to influence the excess pet population, spay and neuter clinics available to the general public were then included. However, some nonprofits are now expanding these activities and opening full-service veterinary clinics in affluent suburbs catering to the general public, in some instances even discouraging clients unable to afford veterinary service.

In addition to being financed and supported through tax-exempt contributions, charitable animal welfare nonprofits have promotional advantages unavailable to their competition. Business owners who have objected to this change in activities have been portrayed as greedy profiteers by the supporters of the nonprofits. The term "nonprofit" is misleading as it refers to a preferred tax structure granted by the government. Certain animal welfare nonprofits report income in the millions with some employee salaries in six figures.

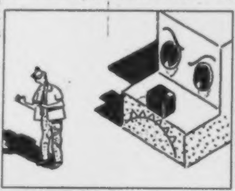
Private, tax-paying veterinarians are finding it increasingly difficult to compete with businesses which are advantaged by this tax structure. Not only is new business affected but some established businesses have been forced to close. When the IRS threatened to revoke the exempt status of one such nonprofit, the organization merely "spun off" their service business with virtually no penalty and still operates the business under the same roof as its nonprofit parent charity.

To finance their growth, nonprofit organizations , which number nearly a million in the U.S., must seek new sources of revenue. Favorable tax laws actually encourage nonprofits to compete with the for-profit sector. Unless our tax laws are changed, there will be a continued shift of business from the tax-paying to the tax-exempt sector. The Michigan Veterinary Medical Association is encouraging lawmakers to consider legislation that would require businesses which primarily provide veterinary service to the general public to all operate under the same tax laws. Tax-exempt nonprofits must be required to limit their activities to areas for which this privileged tax status was granted. This privilege must not be used as a means to unfairly compete with other small businesses!

SUMMER 1986
VOLUME 3 NUMBER 2

VETERINARY Practice Management

A Business Guide for Small-Animal Practitioners



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Special Feature

Humane Societies: Friend or Foe?

Veterinarians across the nation are realizing that humane societies can pose a threat to them by competing for clients and practice profits. Here, they warn colleagues to become aware of the problem and to take steps to combat it now.

6

Working With Your Spouse

With a little foresight and consideration, you and your spouse can have a profitable working relationship and still maintain a satisfying home life.

17

The Rewards Of Serving The Elderly

If you go the extra mile to accommodate the unique needs of senior citizens, the emotional and financial rewards of their patronage will more than repay your efforts.

32

Interviewing For Your First Job

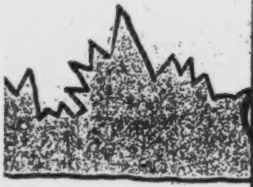
Recent veterinary graduates who have successfully obtained positions in private practice tell students how to make the most of their interviewing opportunities.

48

Passing Your Practice to An Associate

Solo practitioners can follow these guidelines to a smooth transfer of ownership to their associates or outside buyers.

And more...



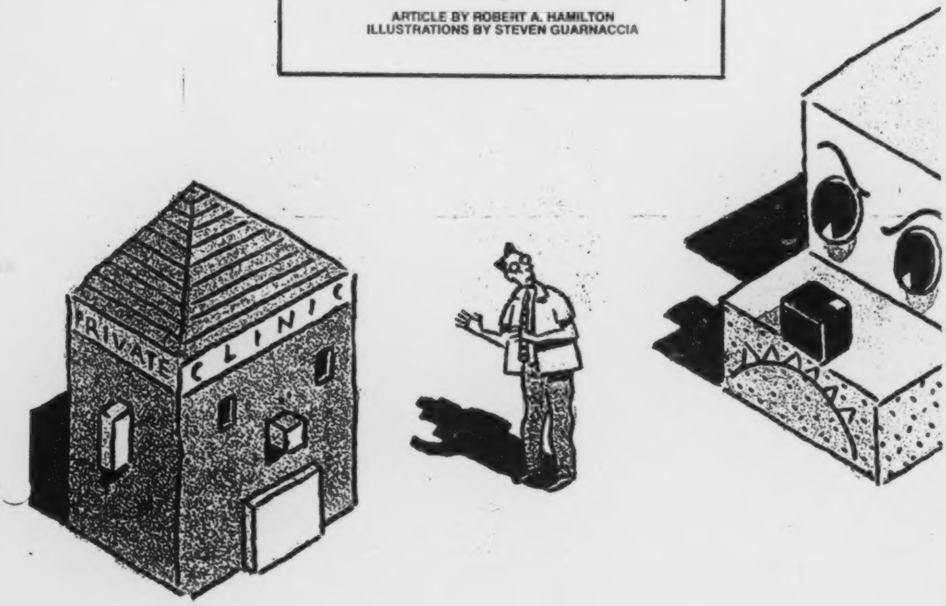
HUMANE SOCIETIES: *Friend* OR FOE?

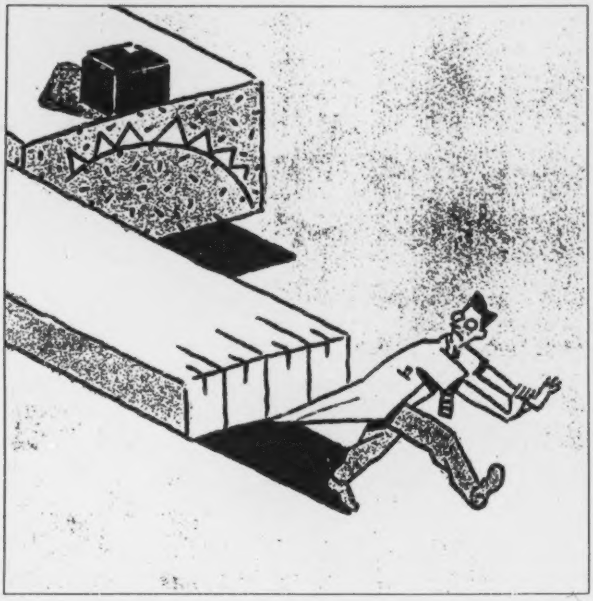
YOUR ANSWER TO THIS QUESTION WILL DEPEND ON THE ACTIONS YOU TAKE.

Dr. Alan Berger's practice in Utica, Michigan, lost a great number of clients when the local humane society opened a full-service clinic in that area. You may consider that an isolated incident—Berger's problem. But veterinarians across the United States have had similar experi-

■

ARTICLE BY ROBERT A. HAMILTON
ILLUSTRATIONS BY STEVEN GUARNACCIA





To prevent the establishment of full-service, nonprofit clinics, you must take action *before* you actually face a threat.

ences. They say that full-service humane society clinics wrongfully take clients from their practices. Humane society officials counter that claim by saying they only answer community needs and promote animal health care.

Regardless of any argument, humane societies have established clinics in some areas, and they plan to stay. You may still have a chance, though, not only to prevent full-service clinics, but also to offer benefits to your humane society and have it reciprocate in kind. By ignoring the issue, you risk disastrous results, as the following case in Utica, Michigan, illustrates.

In 1961, Berger established his practice, Macomb Veterinary Associates, in Utica. Despite competition from other animal hospitals and some tough years for the local economy, "we had 16 years of growth," he says.

Then, in 1978, the Humane Society of Macomb County opened a full-service clinic, and Berger lost more than 40 percent of his clients. Just a coincidence? Not according to Berger. "The humane society has nonprofit status, yet in the humane society's building, they operate a full-service, for-profit clinic that competes with my clinic," says Berger. The humane society's for-profit clinic employs eight full-time associates and treats, by its own estimate, 60 to 90 pets a day.

As of July 1983, humane society chapters owned, operated, or managed 50 clinics nationwide, according to Phyllis Wright, vice-president for companion animals for the Humane Society of the United States (HSUS). Some of those clinics operate for profit, some do not. Regardless, most practitioners strongly feel that a humane society that runs any health-care clinic oversteps its bounds.

Some national humane society officials agree that local chapters should not assume the role of providers of full-service veterinary care. "Primarily, humane societies are established to prevent cruelty to animals and to enhance animal welfare," says Barbara A. Cassidy, national director of animal sheltering and control for the Humane Society of the United States. "Their duties should concentrate on initiating animal-health legislation and providing educational and sheltering programs."

Relationships between humane societies and practitioners often deteriorate when the animal-welfare groups extend services beyond those defined duties. Berger now sees his local chapter as a foe.

"The Utica-area humane society just wanted to make money," says Berger. "It does that by offering low-cost care for clients who could afford a private practitioner's services. I don't think that is its role."

Berger and colleagues from the Michigan Veterinary Medical Association are currently drafting legislation to curtail operations of veterinary clinics run by nonprofit groups in that state. If the legislation passes, the humane society will again assume its "proper role," according to Berger. "It will be able to do anything it wants, except provide veterinary care to people who can afford it," he says. (For more information about the Macomb County dispute, see box, page 27.)

A Common Conflict

The conflict in Utica underlines a problem that is prevalent throughout the country wherever humane society clinics perform low-cost neutering or open full-service clinics. But some communities have worked out arrangements that suit both the humane society and private practitioners and still take care of local animal-health needs. (See box, page 30.)

You can offer your local chapter a number of services, including free examinations for pets adopted through the humane society, low-cost neutering for the society's animals, or as-

The Humane Society of the United States
2100

Barbara A. Cassidy, Humane Society of the United States

STEPHEN FERRY GAMMA-LIAISON

"Sometimes differences of opinion get in the way of a mutually beneficial relationship, but I think both groups can work together."

sistance in organizing local pet-care education programs.

In return, the animal-advocate groups can provide you with valuable referrals or offer such complimentary services as boarding clients' pets.

"We're not against veterinarians making money," says Cassidy. "In fact, many practitioners benefit from their relationship with the society.

"When they offer free or reduced-cost first-time checkups for animals adopted from one of the society's shelters, they often gain clients," she says. "These types of programs are mutually beneficial. They promote better animal care, and better animal care is a goal for both groups."

Of course, such a symbiotic relationship between your practice and the local humane society will probably not develop spontaneously. Establishing a reciprocal arrangement may entail that you settle past differences and anticipate ones that may occur in the future.

Any future problem will most likely center on a chapter's decision to open a full-service clinic, even if it doesn't initially intend to make a profit, says Dr. Ray L. Russell, a former practitioner and executive director of the American Animal Hospital Association. Before you offer your local chapter your services, try to set up an arrangement that precludes the possibility of its cutting into your client base later.

A humane society with a clinic can cull local clients more easily than you can retain them because they have the following advantages, according to Russell and private practitioners:

- **They have greater access to new clients.** "A large number of clients adopt their animals from the humane society's local shelters, so it controls the puppy source," says Michigan practitioner Berger.

When a client wants to get treatment for a new puppy or kitten, he is likely to bring the animal back where he originally got it. That gives the humane society first crack at providing treatment for the many animals it matches with owners each year.

- **They have tax-exempt status.** A practitioner's average investment in his facility, including property, buildings, and equipment, totaled just under $500,000 in 1984, according to a paper Russell delivered at the annual AAHA meeting in San Francisco in 1984. He surveyed 100 animal hospitals in the United States and Canada for his research.

Private practitioners, he points out, must pay taxes and interest on their investments, although humane societies can use private donations to build the same-size facility—or a larger one—and avoid taxes entirely.

- **They can raise capital through donations.** Practitioners usually raise their own start-up capital through loans, although humane societies often rely on donations. In Berger's area, private donations allowed the Macomb County humane society to build a large clinic. In turn, the size of its clinic enabled it to treat a larger number of animals at a lower cost per animal. The society passed that savings on to its clients, offering spays for $45, vaccinations for $19 or $20, office visits for $7, and injections for $1.

According to Berger, to make a profit, he must charge around $70 for a spay and nearly twice as much as the humane society charges for other services. The Humane Society of Macomb County gained those clients interested in getting service at the lowest price, says Berger.

- **They provide simple services in volume, without providing more complicated procedures at a loss.** Unlike private practices, humane society clinics generally offer only the less complicated and more profitable procedures, says Russell.

Simple procedures generally account for as much as one-half of a private practice's revenues, he says. Vaccinations, for example, usually produce about 25 percent of a small practice's income.

Conversely, he says, his 1984 research determined that although surgery costs make up about 24 percent of the expense of operating an animal hospital, they bring in only 17 percent of the income.

Practitioners take a higher loss on X-rays. Outfitting and maintaining X-ray equipment costs 27 percent of the average hospital's annual income, but the service brings only 3 percent of annual revenues.

"A hospital would go broke if it treated only complicated cases," says Russell. If a humane society takes over bread-and-butter procedures, most private animal hospitals cannot survive unless they drastically raise prices. "Or private practitioners might abandon the more complicated cases altogether," says Russell. "That would dramatically reduce potential strides in animal care and new research."

- **They have a public-service image.** Clients often feel they should take their pets to a humane society clinic instead of a private practitioner. They see the veterinarian as greedy because he operates for profit, says Berger. "They consider the humane society a group of caring, compassionate animal lovers, not aggressive competition for local veterinarians." (See chart below.)

Acquaint yourself with all these possibilities before you discount your local humane society as harmless and offer them your full support, says Russell. "I believe in the free-enterprise system. I'm not afraid of competition with anybody, provided we all play by the same rules," he says.

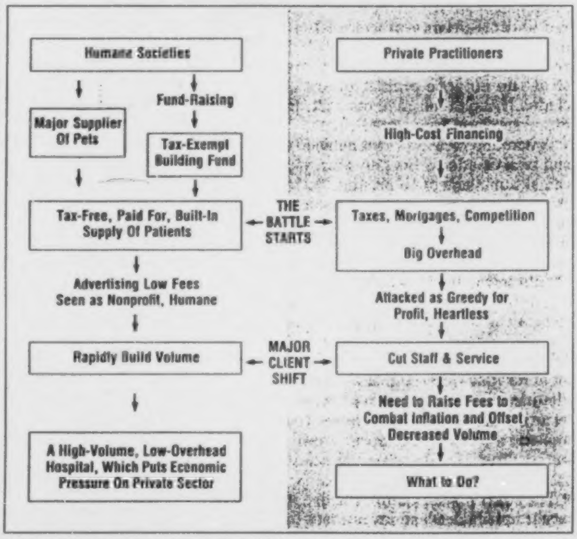
Practitioners do have valid complaints about the humane society's full-service competitive edge. Humane society officials, however, tell another side of the story.

They say they have compelling reasons for opening full-service clinics in certain communities. One of the reasons they cite is that private practitioners don't meet all of the community's needs.

"You wouldn't find a humane society trying to set up a clinic if private practitioners were meeting the needs of the community," Cassidy says. "The society has a responsibility to see that everyone's animal receives proper treatment, not just those owned by indigent people.

"In some cases pet owners, including those who can afford it, won't get care for their pets if they can't find low-cost treatment." In her view, that attitude only hurts the pet, so the humane society has a duty to provide low-cost service for anyone who wants it.

The Issues at a Glance


Humane Societies
Fund-Raising
Major Supplier Of Pets
Tax-Exempt Building Fund
Tax-Free, Paid For, Built-In Supply Of Patients
THE BATTLE STARTS
Advertising Low Fees Seen as Nonprofit, Humane
Rapidly Build Volume
MAJOR CLIENT SHIFT
A High-Volume, Low-Overhead Hospital, Which Puts Economic Pressure On Private Sector
Private Practitioners
High-Cost Financing
Taxes, Mortgages, Competition
Big Overhead
Attacked as Greedy for Profit, Heartless
Cut Staff & Service
Need to Raise Fees to
Combat Inflation and Offset
Decreased Volume
What to Do?

The chart above compares the resources available to private practitioners starting a full-service clinic and those available to a humane society taking on the same task. It also indicates the contrast in the public's perception of each group's endeavor. The chart shows only one outcome when both groups compete for the same clients: economic stability for humane society clinics and financial dilemmas for private practitioners.

SOURCE: Dr. Alan A. Berger, Utica, Michigan.

If you want to prevent a full-service humane society clinic's opening in your community, you must see that affordable care is available to all segments of the population—and you must let the community know that local practitioners have assumed that responsibility.

You can also employ other methods to achieve that end, including:

- Taking preventive steps to discourage full-service clinics in your community.
- Making use of support from an unexpected ally—humane society members themselves.
- Forming your own humane society, keeping goals in line with your professional philosophies.

Practitioners who have actually stopped movements to establish full-service, nonprofit clinics in their areas say that one hard-and-fast rule applies: take preventive action *before* you actually face a threat.

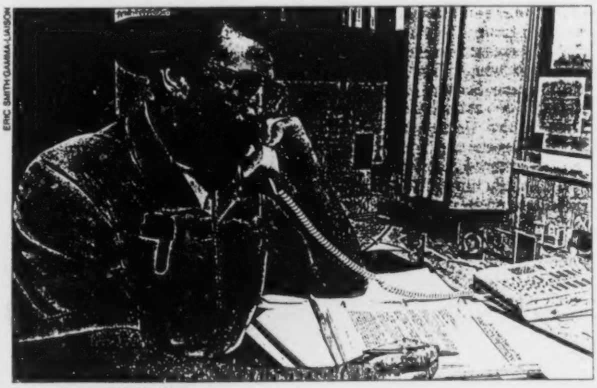
"Once the momentum to establish a clinic begins, it's hard to stop," says Dr. Joseph W. Ciccarelli Jr., the sole practitioner at the Ashdod Animal Hospital in Duxbury, Massachusetts.

He has worked with his local humane society since shortly after he began practicing in 1975. His initial reason for working with the society was not specifically to combat competition, but to organize a cooperative effort to promote animal care in the community.

"By cooperating with its programs when they were started, I was able to have some input in its goals," says Ciccarelli. He helped organize a program whereby local practitioners offered free first-time physicals for pets adopted from the humane society. For a reduced rate, they also vaccinated impounded animals and sterilized animals that people adopted from the humane society shelter.

"Practitioners in this area are certainly demonstrating that they can help the humane society reach its goal for zero-animal-population growth," he says.

"The size of the humane society determines how easily you can deal with it," he adds. "We can settle problems quickly because I know these people. They're hardworking, with their hearts in the right place."


ERIC SMITH GAMMA-LIAISON

Dr. Alan Berger, Utica, Michigan

"When a full-service clinic opened in our area, local practitioners asked themselves, 'What did we do wrong?'"

Some Work Side by Side

In San Mateo, California, local practitioners work side by side with the humane society on educational programs. Practitioners there also give free first-time examinations to adopted animals. Some also provide emergency care at reduced rates for impounded humane society animals. They then donate their fees to the Fluffy-Fido Fund, which makes low- or even no-interest loans to people who cannot afford pet care.

In return, the humane society set up a blood bank in October 1985, drawing blood from animals before they administered euthanasia to them, storing it, then selling it at cost to veterinarians who need it for surgery or emergencies.

Most important, keep the lines of communication open, says Dr. Larry Herbert, sole practitioner at the Aragon Veterinary Clinic in San Mateo, California.

For about 15 years, four or five local practitioners in San Mateo have served on a committee responsible for resolving problems with the humane society. When they originally formed the humane society liaison committee, their goal was to promote better animal care in the community.

But the practitioners' continued cooperation paved the way to more tangible advantages later. They have consistently defeated proposals to establish full-service, nonprofit clinics in their community.

"We have continual problems with the humane society, and the biggest difficulty is that it makes inroads into the veterinary profession," says Herbert, who chairs the committee. "But we have made strides toward solving the problems by talking with humane society officials regularly."

The Peninsula Veterinary Medical Association in San Mateo currently wants the humane society to suspend a feline leukemia vaccination program it operates, for instance, because it cuts into veterinarians' revenues from that same procedure. The two groups are currently negotiating at liaison committee meetings.

"We have convinced them to change some things," says Herbert. "Not as many as we would like, but some, and we're working from there."

Michigan practitioner Berger says the only truly effective way to stop a full-service clinic from opening is to attack the current tax laws.

"When a full-service clinic opened in our area," he says, "local practitioners asked themselves 'What did we do wrong?' We offered educational programs to the public, we offered free care to indigents, and we had a veterinarian on the board of the Macomb County humane society. We thought we did everything right.

"But the bottom line is that the law determining who can have tax-exempt status and what they can do with it is weak. If you get a fireball in a tax-exempt organization, and that individual is an empire-builder, he can turn the organization into a personal empire. We found out that the way the laws are written, the nonprofit groups can screw you any time they want."

To combat weak nonprofit-status tax-exemption laws that he deems "loophole-ridden," Berger says that practitioners should lobby for legislation to change state laws, as he and his colleagues are doing in Michigan.

When you take such steps to prevent the humane society from reducing your client base, you may be able to look to humane society members themselves for help. Some of them feel that practitioners have valid complaints against the group, and they may strive to combat those problems from within the ranks of their local chapters.

Mary Jane Better, for example, helped formulate goals for the newly formed Humane Society of Southeast Michigan (HSSM), based in East Detroit. Its bylaws expressly forbid efforts that exploit the humane society's reputation in order to start moneymaking ventures. Instead, the group has pledged to take an interest in educational programs and cruelty investigations—two areas Better believes properly fall under the jurisdiction of animal-welfare groups.

"I really am discouraged with the course some humane societies take," Better says. "Some societies take an interest in fundraising and building big clinics, yet they don't attempt to strengthen educational programs or develop new ones."

Unfortunately, such bylaws as the

HSSM's have little impact on changing other groups' regulations because chapters operate independently. According to John A. Hoyt, president of the Humane Society of the United States, 2,000 animal-welfare groups exist in the United States. The groups operate under various charters, with varied goals and objectives stated in their organizational bylaws.

Humane society members and private practitioners came up with a watchdog goal similar to Better's when they met together at the 1983 Animal Health Care Symposium, which was sponsored by the American Animal Hospital Association, the American Humane Association, the American Veterinary Medical Association, the HSUS, and the Pet Food Institute. Many private practitioners and humane society members agreed that they should formally define the role of a humane society at the national level. Then they agreed that they should set up guidelines for its operation and provide a forum that would allow a practitioner or community member to bring an errant or interfering society to the national organization for corrective action.

"Veterinarians and humane societies really have the same objective: They're both dedicated to the care and the wellness of animals," says Russell. "It's too bad we don't focus on the things we have in common more often."

Even if you receive help from some humane society members, you may find that asking your own local chapter to concentrate on animal welfare and give up profitmaking activities is a worthless proposition.

If you can't beat 'em, join 'em, says Berger, but only on your own terms. "You can't continue to fight if things aren't working out," he says. "These organizations have millions and millions of dollars to support their efforts. And the more you scream about their methods, the worse you look in the public eye."

Instead of voicing a constant stream of complaints about the Macomb County humane society, Berger has helped organize an alternative, the Humane Society of Southeast Michigan, along with local citizens, including Mary Jane Better. The endeavor requires time and effort—not to mention legal expertise to file for tax-exempt status.

"We have community members and 36 veterinary hospitals that help us care for unwanted dogs and cats," he says. "The practitioners use their hospitals as minishelters, taking unwanted kittens or puppies and displaying them. They also vaccinate the animals for free. When someone adopts an animal, the minishelter charges a fee of about $40.

"We return half of that fee when the client has the animal neutered. The other half goes to our humane society, and we use it to help indigents pay for care.

"We take calls from a practitioner or someone from the Department of Social Services who has identified a person as an indigent in need of care for his animal," Berger says. "One of three practitioners on our board decides whether we can help pay for the care. So far we've never turned anyone down."

The practitioner who treats the animal provides the client with a 20 percent discount. In turn, the HSSM tries to collect 20 percent of the fee from the indigent client. The society pays the rest from donations and adoption fees.

Fighting the 'White Knight' Image

As a result of forming the new humane society, Berger and other local practitioners are regaining control of the puppy source. They also feel they've taken a positive stance in fighting the white knight image of the humane society, rather than taking the offensive.

"And that approach is more in line with my professional values," Berger says. "I believe in animal health care, and the Humane Society of Southeast Michigan gives me an outlet to help provide it—for everyone." ■

Robert A. Hamilton is a reporter for the Willimantic Chronicle *in Willimantic, Connecticut. His work has also appeared in* The New York Times *and the* Harvard Business Review.

A Healthy Relationship

If you despair of ever working out a beneficial relationship with your local humane society, take heart. It can be—and has been—done. The Angell Memorial Animal Hospital in Boston provides a good example. The Massachusetts Society for the Prevention of Cruelty to Animals maintains the facility and allows private practitioners to refer difficult cases to their hospital.

In that way, private practitioners can minimize their losses on complex procedures.

In addition, the hospital doesn't take clients from nearby private practitioners by offering price breaks. "We can provide care for those who truly can't afford it, but we're not going to give it to people who can. That's when the conflict with practitioners usually starts, and rightfully so," says Dr. Gus W. Thornton, chief of staff at the hospital. "We never thought that providing low-cost care for just anyone was our role."

Dr. Richard Hahn says that the rosy situation at Angell would probably not work in many areas.

"They're in the inner city, where few veterinarians practice, and they serve clients we refer from the suburbs. Those clients must drive 25 miles or more to get to Angell. They'd hardly want to drive that distance for routine visits," says Hahn, the sole practitioner at the Wilmington Animal Hospital in Wilmington, Massachusetts.

"None of us sees Angell as competition," he adds. "We think of it first as a teaching hospital and second as a referral hospital. Few practitioners consider it primarily a humane society clinic."

"For a relationship between private practitioners and the humane society to work in any community, the society should concentrate on investigating animal cruelty and sponsoring animal-health education programs, and avoid offering services that compete with those offered by private practitioners in their area," says Thornton. □

Down and Out in Utica

Private practitioners and their local humane society take their conflict to court.

Conflicts between private practitioners and their local humane societies can and do erupt. However, few reach the proportions of the dispute that occurred in Utica, Michigan, when the Humane Society of Macomb County opened a $250,000 full-service clinic in 1978.

Dr. Alan Berger, a private practitioner at the nearby Macomb Veterinary Associates, saw his client base shrink 40 percent in four years. His practice gained 1,500 new clients in 1978, but that number gradually dropped, decreasing to fewer than 500 new clients in 1983. He now employs only half of the personnel he did in late 1978.

The number of private clinics within a three-mile radius of Utica also fell from four in 1978 to two in 1983. "Take this as a warning, and wake up," says Berger. "It's happened here, and it could happen anywhere."

Berger has invested a great deal of time and money to combat the Humane Society of Macomb County Animal Clinic. His major complaint concerns the tax-exempt status of the society's animal clinic, which local practitioners in Utica say competes unfairly with their tax-paying operations.

George Fox, director of the Macomb County humane society and its full-service clinic, defends his position: "We initially opened the clinic to take care of the poor."

Berger lambasts Fox's claim. "If you called their clinic and asked about indigent care, they'd have no idea what you were talking about."

When *Veterinary Practice Management* called Fox for his reply, he said the fact that his clinic never collected 10 percent of its bills was evidence that he did offer care for indigents. When pressed, he admitted that they had no set program to offer indigents free or low-cost care, only that they arranged deferred payments for those who couldn't pay at the time of treatment. Fox also amended his initial statement that his purpose in opening the clinic was to provide for the poor. "We provide for everybody in between, too. The price of private veterinary medicine in Macomb County just keeps climbing, and we offer affordable care."

The society can offer more affordable care than private practitioners, according to Berger, because of their nonprofit status and a mortgage-free facility paid for by tax-exempt contributions. He complained about this publicly in 1980, with letters to his local newspaper and speaking engagements at veterinary seminars.

Other local practitioners aired similar views. "We were attacked unmercifully," Berger says. "Local newspapers happily printed more than 100 anti-private-practice letters. My clinic was picketed, and I even received a death threat."

But the private practitioners eventually took their case to court. With assistance from the Michigan Veterinary Medical Association and local practitioners, Berger spearheaded a movement to prompt the Internal Revenue Service to revoke the tax-exempt status of such clinics. They succeeded, but they paid thousands of dollars in legal fees.

In January 1982, the IRS concluded that it would consider the provision of veterinary services for a fee as an unrelated business activity. The Macomb County humane society must pay taxes on that portion of its income, retroactive to 1979.

The results of that ruling weren't as positive as the practitioners expected. The Macomb County humane society retained nonprofit status for its overall operation. Berger and his colleagues are now attempting to draft legislation that restricts all activities of groups with nonprofit status in Michigan.

Battle lines were drawn again in 1980, when Berger and a number of private citizens and veterinarians filed a complaint in Macomb County Circuit Court alleging that the humane society had not opened its membership to the general public.

Out of court, they accused the society of setting bylaws that enabled its principal members and board of directors to benefit from their own decisions. For instance, board members held positions as employees and set their own salaries. The humane society agreed to maintain an open membership in an out-of-court settlement in 1980.

But 1982 found both groups back in court. The private sector charged that the humane society had violated their out-of-court agreement, and were not letting new members join the Macomb County humane society, even if they held previous memberships. In that case, the original settlement was overruled by a judge who validated Fox's exclusive membership tactics by comparing them to the standards for membership at the judge's exclusive country club.

Such a setback disheartened Berger, but he and his colleagues continue their attempts at tax-exempt status reform. Berger hopes that support for his efforts will soon come from private practitioners across the nation.

"We all have to realize that a ruling in one state will affect us all," he says. "Those organizations that open full-service clinics based on their tax-exempt status are trying to take over veterinary medicine. They'll soon have all practitioners working under the direction of people who have no veterinary experience whatsoever.

"You go to bed at night content, thinking you're doing your job with a clear conscience. But if the right person gets in there with that loophole-ridden tax break and the humane society name, he can take over your job."

—*Rose R. Kennedy*
Assistant Editor

Business Coalition For
FAIR COMPETITION

December 23, 1985

Similar letter sent
to Debbie Stabenow

Mr. Mark Hilpert
Senate Republication Office
900 Farnum Building
Lansing, Michigan 48909

Dear Senator Hilpert:

The Business Coalition for Fair Competition has been asked by veterinarians in Michigan to comment on proposed legislation that would prohibit nonprofit corporations in Michigan from owning, operating, leasing, or providing a veterinary practice or service. A copy of the proposed legislation is enclosed with this letter.

We have examined the draft bill as submitted to us and endorse its concept; namely, that tax-exempt nonprofits should be prohibited from entering commercial business ventures as long as they retain their nonprofit status with its attendant privileges.

The fact that veterinarians in Michigan are seeking this type of legislation is one example of the degree to which the problem of unfair competition from tax-exempt nonprofit organizations is felt by the small business community.

While we would be interested in seeing the legislation broadened to address unfair competition practices in other industries as well, we feel that the success of this bill will inspire other small businesses to seek a legislative remedy for their problems. We applaud the industrious efforts of Michigan's veterinarians for working to solve a very serious problem, and we are pleased to support their cause.

We would like to make a few comments regarding specific provisions of the legislation. With respect to Section 1, (5), (B), we suggest that the intent of this provision be modified. A nonprofit corporation proposing to launch a new service should be required to demonstrate that a need for the service cannot be met by any private, tax-paying concern. In many instances, nonprofits justify their business activities by claiming that they are serving a population which needs their services. Such a claim should be backed up by evidence that no tax-paying concern exists which can fill the same need. It is extremely unlikely that private businesses would be unwilling to provide the same service.

We feel that this change will aid in discouraging new starts of commercial ventures by nonprofit groups. The exemption certification provided for in the draft legislation should not be granted unless, as a preliminary, the nonprofit can prove the community truly has an unmet need for its service.

We appreciate this opportunity to comment on the proposed legislation. While this bill is limited to a specific application of Michigan law, it has national implications. By adopting legislation of this nature, the state of Michigan may serve as a national model for other state legislatures who are working on the same problems. Your interest in this issue is very much appreciated by the small business community. We hope you will continue to work with small business in solving the problem of unfair competition.

Sincerely,

Kenton Pattie

Kenton Pattie, Chairman
State Activities Committee

cc: Dr. Alan Berger
Roger Haynes, NFIB-MI

Enclosure: Draft with suggested change noted.

National Federation of
Independent Business

Vol. III, No. 5

NFIB™ Speaks Out

May 1978

Special Edition for Trade Publications

Editor's Note

On various occasions NFIB has polled its members on the issue of the government selling goods and services in competition with the private sector. On all occasions, approximately 80 percent said they oppose such competition by the government.

Yet the government at times deems it necessary to solve a particular social or economic problem by providing goods and services in competition with the private sector. The article below is an example of the problems that arise when any segment of government makes such a decision. This problem raises questions: Should the government ever compete in the free market system? If so, when and why?

Marty =
This should be of interest to you
Mike

Is Business Government's Business?

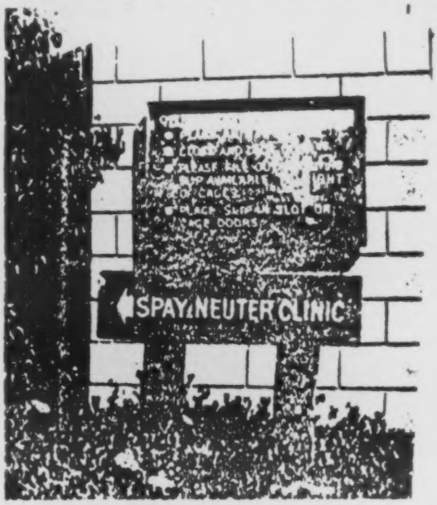
"Government shouldn't go into business unless it can be shown that the private sector isn't doing the job," said Hank Kunnen, doctor of veterinary medicine in Seattle, Washington.

At present, the government's involvement in the private sector greatly concerns Dr. Kunnen, because Seattle's Mayor has promoted establishment of a city-run, spay/neuter clinic which will be in direct competition with Kunnen's business. The mayor and other proponents of the proposed low-cost clinic believe that it will greatly reduce Seattle's animal control problem.

One Seattle couple donated $50,000 for the project and advertising campaigns have raised another $100,000, enough to pay for the construction of the clinic, according to Mayor Charles Royer's aides. Proponents say the annual projected operating costs of about $125,000 will be paid for by spay/neuter fees and an additional tax on nonsterilized pets. Therefore, the clinic would be maintained with no cost to the taxpayer.

"I'm very skeptical about their method of financing the clinic," said John Miller, a Seattle City Councilman. "They estimate that about a quarter will come from fees and the rest will come from raising the license fee on unaltered pets. One problem is that there seems to be a correlation between people with unaltered pets and people who don't license their animals." He added that if the proposed method of financing doesn't cover costs, the taxpayer will end up subsidizing it.

Miller believes that the government should ask itself five questions before selling goods and services in competition with the private sector.



"Only 13 percent say they have not had their dogs altered just because of high veterinary fees."

I IS THERE AN OVERWHELMING PUBLIC NEED? In
tle, for example, animal control problems due to unal
animals has greatly diminished since the introdu
several years ago of biased license fees. (In Seattle
ers of unaltered pets pay a higher license fee than
with altered pets.) The percentage of licensed c
tered has reached 88 percent, while the percent
licensed dogs altered has climbed to 52 percent,
Councilman Miller.

Dr. Kunnen added that the number of animals h
by Seattle's animal control decreased by 45 perce
the surplus animals destroyed decreased by 48 p
(Proponents of the clinic maintain that this decr
due to budget and personnel cutbacks.)

A survey of owners of licensed unaltered dogs in
also lends support to the contention that a city-o
clinic is an unnecessary use of funds. Only 13

HELP PRESERVE THE ABILITY OF NONPROFIT HUMAN SERVICE ORGANIZATIONS TO SERVE YOUR COMMUNITY

The White House Conference on Small Business pays tribute to a proud American tradition: small business persons creating prosperity for their communities. It also has become a forum for small business persons to discuss another American tradition: provision of health and human services by nonprofit organizations. If we are to remain a free and caring society, we must nurture both traditions. Proposals before the conference to bar nonprofits from competing with for-profit businesses would sharply curtail essential charitable activities in your community.

NONPROFIT HUMAN SERVICE ORGANIZATIONS ARE FOR EVERYONE

For decades, communities across America have looked to our organizations for child care for working parents, counseling for troubled families, camps, and other character-building programs for youth, health care, vocational training, recreation and fitness programs, and other important human services. We provide these services to the whole community, rich and poor, typically charging sliding-scale fees based on ability to pay. In short, charities make communities a better place to live and work, where businesses are able to recruit and maintain a productive work force and operate in a safer and more congenial environment.

COMMUNITIES BENEFIT BECAUSE NONPROFITS DO NOT SERVE JUST THE POOR

In recent years, for-profit firms have begun to offer many of these same services for a fee to people who can be served at a profit. While this provides new service options, we do not believe it means that the only role for nonprofits is to serve those who cannot pay. Yet barring nonprofits from competing with for-profits would have precisely this result.

The community is better served because we do not serve just the poor. Indeed, charities cannot survive on contributions alone. Human services are often highly personal. Many people, not just the poor, want to receive such services from a religious or other nonprofit organization that they know and trust. By charging fees to those who can pay, we are better able to serve those who cannot pay. It also enables us to serve the large number of working people who do not qualify for public services, but cannot afford to pay the full cost of private services. By serving the needy side by side with the middle class, we help bring them into the mainstream of society. In short, by serving everyone we help to create that sense of community that makes our cities and towns better places to live and work.

EXISTING LAWS ARE EQUITABLE AND ENFORCEABLE

The Unrelated Business Income Tax law, added to the Internal Revenue Code in 1950, already addresses the problem of unfair competition between nonprofit and for-profit organizations. Greater education and awareness about the law, coupled with vigorous enforcement by the Internal Revenue Service, are effective alternatives to new legislation.

PLEASE DO NOT VOTE FOR RESOLUTIONS THAT UNDERMINE NONPROFIT ORGANIZATIONS. URGE THAT THIS ISSUE BE ADDRESSED BY EXISTING LAW.

American Red Cross
Boys Clubs of America
Camp Fire, Inc.
Child Welfare League of America, Inc.
Council of Jewish Federations, Inc.
Family Service America
Goodwill Industries of America, Inc.
Lutheran Social Services System
National Board of the YWCA of the U.S.A.
National Easter Seal Society
The National Assembly of National Voluntary Health and Social Welfare Organizations, Inc.
United Way of America
Volunteers of America
YMCA of the U.S.A.

Mr T.
send this to mody Andrews

DME Crisis Committee
P.O. Box 5416
Plymouth, Michigan 48170-5416
313 - 459-3115

BOB MAYER
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CHUCK NELSON
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FOR IMMEDIATE RELEASE

FOR MORE INFORMATION CONTACT MR. ROBERT MAYER

LANSING--"Consumers will suffer and private businesses will close their doors if non-profit community institutions are allowed to continue to use vast amounts of tax free dollars to undercut the State's free enterprise system", said Bob Mayer, President of the Michigan Durable Medical Equipment Crisis Committee.

The D.M.E. Crisis Committee is a group of independent business people involved in home health care and related services that was organized recently to confront issues that Mayer says will monopolize the health care industry if current trends continue.

The group met in urgent session recently in Lansing at the Midway Motor Lodge to develop a strategy to deal with the problems that have been created by the State's non-profit hospitals, Mayer added.

Following the meeting, Mayer issued this statement:

"This group of business people was organized because each of us has a large investment in the communities we serve. We represent every area of the State. The problems we are running into border on the unbelievable in some areas and the time has come to take action to stop what is blatantly unfair and in most cases probably outright unlawful."

Chuck Nelson, President of Michigan Medical Supply, Inc. of Traverse City added: "We don't object to competition as long as it is a force that promotes better health care services and prices for consumers. We encourage competition because it's competition that makes our system work best. But the only way we can compete fairly with any group or business is if we all play by the same rules and pay the same taxes."

Chuck Clevenger, President of Professional Medical Equipment of Holland, stated: "In Michigan our non-profit hospitals are using non-profit funds generated from patient revenues to set up businesses that have nothing to do with health care. Hospital administrators will say that these businesses are being set up to generate money for the hospital and to provide their facilities with more money. This is a farce. Our question is why don't they use these funds to reduce the cost of hospital care for the people they serve? A recent study indicates that Michigan was the second in the nation in terms of increased health care costs and the picture isn't looking any brighter for the future."

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The practices of the non-profits are going to create a climate that will allow very large non-profit hospitals to control every aspect of health care and related services as we know them today. No longer will consumers have the opportunity to look around for the best prices and services for their health care needs but will be forced to deal with a few very large institutions. What does this mean to the average consumer of health care? It means that these very large non-profits will be able to charge what they want to charge, deliver what level of services they want to deliver and consumers will be forced to accept whatever the larger supplier wants to dish out. We think consumers need to be made aware of what's going on in an area that will touch every person that one day may need the services of a health care provider.

Frank Sutton, President of Wayne Surgical Supply, Livonia added: "Currently hundreds of durable medical equipment dealers compete for a share of the D.M.E. business. Consumers reap the benefits of this competition because each dealer must maintain a high level of service in order to attract customers. Hospitals have now setup their own D.M.E. business in many areas and patients discharged from hospitals are being steered directly to the hospital-owned D.M.E. business. Reports indicate that consumers aren't being told that many dealers are available who can provide the same service. The D.M.E. business is but one area where hospitals have entered into other business ventures. Hospitals have created complex, private holding companies to operate travel agencies, hotels, liquor clubs, laundry services, collection agencies, restaurants, and a variety of other ventures. Money to back these businesses comes from non-profit funds -- funds that include patient revenues. Private business people must compete on the open market when they need money and are subjected to market forces that never touch non-profit institutions. As the non-profits continue their expansion into private business, independent business people will be forced to sit down and unemployment will rise. Doctors in some areas of Michigan have expressed alarm as non-profits begin to establish private medical practices. Most physicians view the practice of medicine as an art and a science -- not something to be used as a bargaining chip in the marketplace. Our group is not alone in our concerns for what the non-profits are attempting to accomplish. Private tax paying business people resent competing with giant non-profits with limitless cash supplies and they, too are prepared to stand and demand what's fair. Our support is not only in Michigan but is coming from all across the country where other non-profits are driving independents out of business. Their battle has just begun".

Mayer added that his group will seek urgent legislative action to deal with the problem and will also file complaints with the Federal Trade Commission, which has indicated just recently that anti-competitive problems are cropping up in the health care industry.

Headline reads: Hospitals sell more than health care today

Sun / Detroit News PG-3-SECTION A-3 10-27-85

ug Ilka
ane Katz
l Writers

ested in buying a little pate de foie from Mt. Clemens General Hospital? about arranging for the dream vacation he Bahamas through Beaumont Hospital oyal Oak? Or, maybe getting a stack of ess cards printed through Riverside pathic Hospital in Trenton?

hat's all possible today.

Shrinking revenues and growing ex- es are prompting many Metro Detroit pitals to offer such nonmedical, commer- services. It's a matter of survival.

ROM CATERING parties to dry ning, from real estate deals to fast-food ts, more and more medical centers are ching out of their antiseptic wards into germ-filled marketplace.

o their delight, many of the hospitals finding that there is money to be made there. The money supplements the ocketing costs of healing people at a when more hospital beds go unused, n competition is on the rise, when employers are curtailing insurance coverage and operating costs are increasing.

While some traditionalists in the medical field are clucking their tongues over these nonmedical forays, there is general agreement that many hospitals have little choice.

"The more that hospitals diversify, the more likely they are to survive," said Dr. Daniel R. Longo, director of research for the Joint Committee on Accreditation of Hospitals, the Chicago-based accrediting body of the nation's medical centers.

"THIS ATTEMPT to accumulate capital is an approach that's been used by other nonprofit enterprises for years. Hospitals now are realizing they can be innovative, too. They should be applauded for taking action in a period of dwindling resources."

So, you can go to Mt. Clemens General for surgery or some deli treats.

The Macomb County hospital is battling the budget crunch with revenues collected from its General Store and Deli, a basement operation open to the public and offering a break from fast-food fare. A catering service for private parties also keeps the deli staff busy on weekends.

Please see **Hospitals / 13A**

NEWS PHOTO / WILLIAM T. ANDERSON

Deli treats are available in the basement of Mt. Clemens General Hospital.

Hospitals

They're selling more than health care today

From page 3A

"We can compete with any caterer in town," said Ron Schwark, the main force behind the hospital's Custom Cuisine Caterers. "And the food business also is good public relations for the hospital. It gets our name out in the community and lets people know that we're the same people who provide the hospital food."

HOW MUCH cash do all those croissants and crab meat salads bring in? Schwark said the food business is expected to net $30,000 this year on $200,000 in sales.

Administrators at Royal Oak's Beaumont Hospital talk in the same dollar and cents terms.

Beaumont is considered by many to be the local pioneer of diversification. In addition to owning the mall at Woodward and 13 Mile, Beaumont's for-profit subsidiary, Shared Services Inc., runs a travel agency and florist shop, markets medical equipment to the public and sells computer and management services to other medical concerns.

"We started in the mid-1970s to raise money to meet hospital costs and improve services," said Brian Dunphy, director of marketing services. "For competitive reasons, we prefer not to provide any income figures."

DETROIT'S HUTZEL Hospital pushes hot dogs and pizza for profit at football games in the Pontiac Silverdome. It also operates a savings and loan company and dry cleaning service. Officials said the business ventures will net more than $200,000 to finance new kidney dialysis machines, an auditorium for medical school lectures and other in-house improvements.

Not all of Hutzel's hustles have brought success, however. Its gas station closed recently "because it wasn't profitable," said Lou Acierno, a hospital spokesman.

"We're trying to market the hospital, to get our name out and let people know what we're doing," he said. "It's hard to get people from the suburbs to come to a Detroit hospital for treatment because of our location in the Medical Center. Most of our patients are Medicaid and Medicare and we lose money on every one of them. We need to get some good Blue Cross-Blue Shield patients in here."

The Horizon Health System, the parent corporation of Detroit Osteopathic Hospital, Warren's Bi-County Hospital and Riverside Osteopathic Hospital in Trenton, expects to net $1 million next year from its 3-year-old commercial printing business. The corporation also runs a personnel agency and clinical engineering service that together generate more than $2.5 million a year.

"OUR SOURCES of capital are becoming more and more scarce," said Philip Incarnati, executive vice-president and chief officer of the Detroit Osteopathic Hospital Corp. "We saw the need for this coming and there was a recognition that the market was changing."

Like many other hospital corporations, Horizon took advantage of its in-house resources to develop outside ventures. For years, for example, the company ran its own printing operations. So with trained employes and equipment on hand, it wasn't too difficult to expand.

Not only do these sideline businesses bring in extra cash, but they also cut expenditures once needed for contracted services.

BUT NOT all hospitals are ready to compete with Burger King or the likes of business entrepreneur Al Taubman. Southfield's Providence Hospital is sticking to medical moneymakers like its satellite offices in South Lyon and Brighton, and a 24-hour trauma center in Novi.

"We are exploring a restructuring in the corporation for profit to support the main work of the hospital — but nothing as grand as Beaumont Hospital," said Pat Evans, director of community relations.

Other Metro Detroit hospitals rely on more traditional methods of fund raising. Children's Hospital, for example, depends on public donations, grants, estate gifts and benefits to fatten its operating budget.

The apparent success of nonmedical ventures does not draw applause from all medical professionals. Some express concern that the profit motive may interfere with the hospitals' primary mission — to provide quality health care.

"I DON'T blame the hospitals for doing what they are doing, but it raises a lot of questions," said Professor Sylvester [illegible] of the University of Michigan [illegible]

"They now have to put more emphasis on surviving and less emphasis on care. They become merchants. I would put the blame on a system that doesn't recognize that quality health care must come first."

This diversification is a boon to management and marketing consultants who are needed [illegible] than ever [illegible]

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Oriental Rugs
GENUINE HAND WOVEN IMPORTS
SALES AND SERVICE
EXPERT CLEANING & REPAIR
WE BUY USED RUGS

June 27, 1985

BASE

Atten: Ms. Marty Andrews

Dear Ms. Andrews:

As an established retail business of oriental rugs in the Detroit metropolitan area, I wish to express the following concern. In October of 1983 a local church engaged in a four day oriental rug sale. The gross sales amounted to a figure around $300,000 with the church receiving a commission. The radio and newspaper ads stated wholesale(the advertising paid by the New York importer). The purchase payments were cash or check (made to the church). An extensive direct mailing was done using the church's non-profit permit.

No retailer in this free enterprise system can compete with this illegal operation. The buyer pays no salestax, the church and importer advertise falsely (prices were retail) and the church backsup the importer with their credibility.

The retailers lose business due to unfair competition, the State loses tax revenue, the federal government loses revenue(consumer may deduct pufchase), and the New York importer gets away with " dumping " his goods, and the church maintains its tax exempt status.

Local merchants have expressed their concern to the church to no avail. A second sale was held in May of 1984. The State collected sales tax, due to pressure from local merchants. (Why didn't they take the $12,000 owed them from the first sale?)

If this unfair practice is not stopped soon , a precedent will be set for all tax exempt organizations to compete with any and all varieties of retail and service businesses.

It is my hope the voice of BASE will be heard.

Sincerely,

George Nigosian
Owner

ANNUAL REPORT
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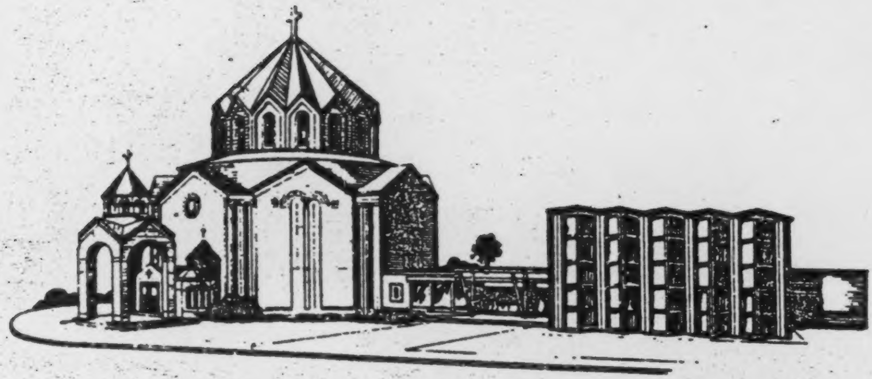


ST. JOHN'S ARMENIAN CHURCH OF GREATER DETROIT

22001 Northwestern Highway

Southfield, Michigan 48075

The other situation, which is church sales as a business marketing technique gets a lot more response, and a lot more heated response. We have heard of specific instances where customers have pointed out to regular oriental rug dealers the benefit of buying through the church, because with a 50% tax bracket, it made the purchase financially desireable. One dealer even went so far as to say that his sales fell off for two months after a church sale. Because of the tax effects of selling through the church, and again we are not tax experts, but we have heard that consumers claim they will be able to take tax deductions on checks written to a church for merchandise. *

We obviously think that church sales are not in the industry's collective best interest, but we don't see how to stop them. The churches promoting them aren't going to stop. The suppliers aren't going to stop because if the churches promote, some supplier will get the business and it is a question of which supplier. The consumer won't stop because he sees only a benefit and no penalty. We don't see the abuse of the tax laws becoming sufficiently great for a major IRS crackdown which means consumers won't see a penalty. The few that get caught in an audit probably won't be enough to ensure voluntary compliance. We still welcome comments but we don't see any easy answers. L.S., editor. oH?

RUMOR AND REPORT: ORIA ON CHURCH SALES

Rug News believes that the Oriental Rug Importers Association will issue a statement in opposition to church sales of oriental rugs. We hope that they will also encourage more comments from retailers who are affected by this activity. We will ask ORRA for their position as well.

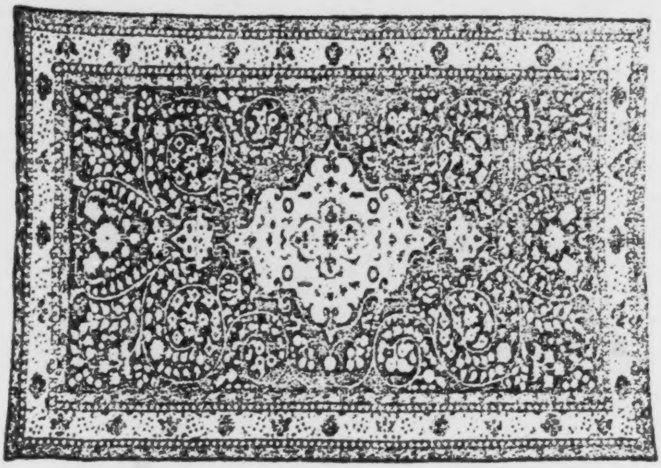
$300 FARE ROUNDTRIP EAST COAST TO WEST COAST FOR ORRA SHOW NOW $360

Prices for flying to San Francisco, and more importantly, returning, just as the Olympics are ending were raised by World Air-

$2,000,000

SALE
FINE ORIENTAL RUGS

WHOLESALE PRICES • SAVE 35-50 %



A NOTED NEW YORK IMPORTER HAS ESPECIALLY SELECTED PIECES FOR THIS SALE FROM HIS VAST INVENTORY OF HAND-MADE RUGS FROM PERSIA, INDIA, PAKISTAN, CHINA AND ROUMANIA.

Sponsored by

ST. JOHN'S ARMENIAN CHURCH

Sale held in RECREATION CENTER

— 4 DAYS ONLY —

THURSDAY May 17 6 p.m. – 10 p.m.	FRIDAY May 18 12 noon – 10 p.m.	SATURDAY May 19 10 a.m. – 7 p.m.	SUNDAY May 20 12:30 p.m. – 6 p.m.

VARIETY OF TYPES AND SIZES AVAILABLE.

Bokharas, Kilims, Dhurries, Kermans, Ardabils, Herez Kashans, Tabriz, Silks and many more.

(Oriental rug experts available at all times to assist you with your selection.)

TERMS: Cash or Check payable to St. John's Armenian Church

PHONE (313) 569-3405

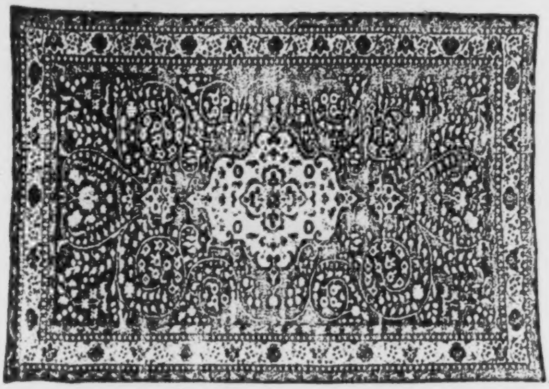
(over)

$2,000,000

SALE

FINE ORIENTAL RUGS

WHOLESALE PRICES • SAVE 35-50 %



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(Oriental rug experts available at all times to assist you with your selection.)

TERMS: Cash or Check payable to St. John's Armenian Church

PHONE

Church Paper

ORIENTAL RUG SALE

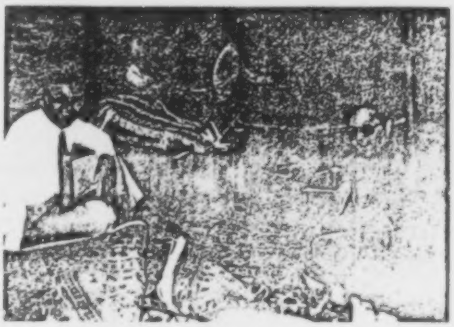
St. John's Armenian Church sponsored a very successful four day Oriental Rug Sale in conjunction with Edward Bashian and Sons, Inc., importers from New York City, on October 27-30.

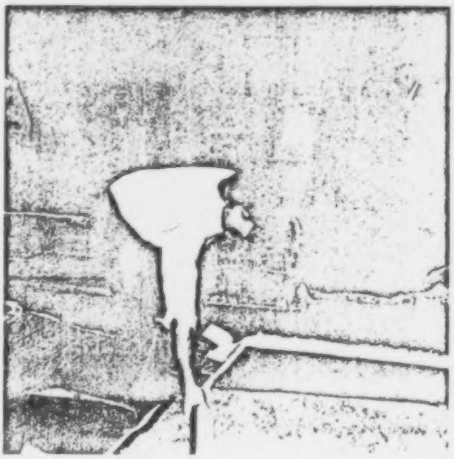
In an effort to raise funds to meet budgetary items, the Parish Council decided upon this fund-raiser in mid-1983 and held a preliminary meeting with Mr. Paul Bashian. Parishioner Guy Amboian was recruited to assist in the planning and to use his expertise in public relations to head a major advertising campaign. When the final decision was reached, representatives of the Parish Council formed an executive committee, chaired by Arthur Apkarian, to proceed with the arrangements. This special committee included, on behalf of the Council, George Cross, John Kalajian, and Victoria Reizian.

Five newspapers in the Metropolitan Detroit Area featured extensive advertisements which were reinforced by numerous radio announcements. The response was overwhelming.

St. John's Recreation Center Gymnasium was the scene of the gigantic sale. Opening day was devoted exclusively for St. John's pledge members to make their selections; an added incentive on that day was a special discount along with the already discounted prices. Doors were open to the general public on the following three days.

Our thanks to Paul Bashian and to Frank Avakian Stoneson, Director of the Diocese for the benefit of their experience during the pre-planning stages and for their assistance throughout the weekend of the Sale. We extend our appreciation also to Guy Amboian for his efforts and also to the many parishioners, particularly the ladies, who extended their assistance in processing and expediting the sales.





BAZAAR '83

St. John's Armenian Church Bazaar '83 attracted thousands of visitors during the weekend of November 11, 12, 13 and proved to be an overwhelming success both financially and socially. Since St. John's was presented with a Orchid Award for historical preservation and environmental planning in the Orchids and Onions Community Awareness Program sponsored by the Michigan Chapter of the American Society of Interior Designers, the Michigan Council for the Arts, the American Society of Landscape Architects and the Designers Lighting Forum, the Orchid theme was reflected in every aspect of the Bazaar offering a delightful variation to the decor of past bazaars.

STATEMENT OF CATHOLIC CHARITIES USA

on

Competition and the Unrelated Business Income Tax

for the

Subcommitte on Oversight

Committee on Ways and Means

June, 1987

Catholic Charities USA welcomes the opportunity to present this statement on behalf of its affiliates for the subcommittee's important oversight hearing on competition and the unrelated business income tax. There have been many charges that unfair competition between nonprofit or organizations and small business has been spreading and so we believe the subcommittee's first look at these issues since 1969 is important and will help us all clarify the role of nonprofits in the life of our communities.

Our agencies are fully committed to accountability to the public. We believe that our provision of human services, under the laws governing nonprofit organizations, requires that we meet the public trust, and thus we disclose, as appropriate, information on the activities carried out under our charitable mission, and provide complete disclosure on our income and expenses as well. Our agencies do this in their local communities, and we do it in the publication of an annual survey to the extent that we are provided this information by our affiliated or member organizations.

Catholic Charities USA is a member of the Independent Sector as well as of the National Assembly and the Grants and Contracts Project. We have worked with these coalitions in the preparation of their recommendations to this subcommittee, and want to associate ourselves with those recommendations.

Catholic Charities Agencies provides a broad range of human services in their local communities (See 1985 Annual Survey appended.). These range from providing emergency assistance, food and shelter, to sponsoring and managing government subsidized housing projects for low income families, the handicapped and elderly. We provide the traditional social services of pregnancy counseling, adoptions, counseling in situations of family abuse, conflict, and other problem areas. We have staff working with local churches and neighborhood groups trying to strengthen the fabric of neighborhood life and trying to resolve issues of importance to local communities and various groups of citizens.

Our agencies have resettled a great majority of the refugees who have come to this country in recent decades, and are deeply involved in the newly passed amnesty program involving undocumented aliens seeking permanent residence in the United States. They also provide health services for low income or homeless people, provide advocacy services so citizens can receive their entitlements, provide consultation to government bodies on human service programs, and conduct community education on important social issues related to our mission and community needs.

The activities of Catholic Charities Agencies are financed through donated funds, through donated in-kind salary contributions and space facilities contributions, through foundation grants. In 1985 these sources provided 25.2% of our local agency cash income.

Another major segment of our agencies' financing comes through the purchase by local or state government of services. This has come to be the largest single source of the funding for most of our agencies in recent decades, as the policy decisions by the Federal, state and local government have enabled all human services agencies to reach out and extend services to millions of citizens not previously provided these services adequately because of the limited availability of donative income. In 1985 the purchase of service by government from our agencies provided 46.4% of their cash revenues.

There are some troubling questions an agency has to ask whenever this source of income is so high. And our agencies do ask themselves those questions. But by and large this pluralistic government/nonprofit partnership has provided a major resource for under served communities of poor, elderly and other populations. It is also uniquely American in that it has provided services through a mediating sector, and not made the state or the government the source of all services. The same partnership exists in the field of medicine.

The third major source of income financing of our programs is fees for services, which equaled 19.2% of our agencies' cash income in 1985. Not all of our activities have fee income, though typically many counseling services do, and the expensive services provided in arranging an adoption do. Many services are provided on a sliding fee scale.

We should note here that government funding and fees for services are not new sources of income for Catholic Charities programs. In one way or another they have been with us from our beginnings, and always related to our charitable purpose. Even before Catholic Charities was well organized in this country there were federal and state grants to religiously sponsored human service institutions.

It is true, however, that the increased involvement of government in purchasing services, and the increased federal funds involved in recent decades, has attracted for-profit entrepreneurs. This apparent competition does not bother us, unless "creaming" takes place, and the nonprofit sector loses the fees necessary to provide quality services for the poor who cannot pay.

We are unaware of any significant instances or charge of unfair competition involving any of our agencies. But we are troubled by vague and general charges coming from some economic sectors which even contest the legitimacy of government and fee for services income to nonprofits. We are also troubled by some business efforts to set aside funding for small business exclusively. It is our impression that the set-aside laws were designed to enhance the ability of small business to compete with big business. In effect, the way in which they are drafted and administered, they are increasingly sharpening the issue between some small business segments and nonprofits as well.

For the program year 1985 our agencies income from investments equaled 2.6% of their total income. It is our impression that this is all passive income. We are unaware of any commercial subsidiaries or joint ventures.

For that year, also, our agencies reported to us unrelated business income equal to .3% of their total income. 27 agencies were involved. Since we have only recently added this category to our reporting system, we contacted each of the 27 agencies to see what kinds of income were involved. Upon re-examination, the income reported in this category by 26 of the agencies was not unrelated business income by any stretch of the law. In many cases it involved transfer between divisions or branches of the same agency. We plan to sharpen the instructions on this item of our survey, for it does indicated the possibility of unfamiliarity with the precise requirements of the UBIT law. We are also mailing each of our agencies an extensive document on UBIT, and of course, would welcome assistance from the Internal Revenue Service on this. If our agencies are engaged in any unrelated business, we and they believe the appropriate tax must be paid.

The 27th agency reporting unrelated business income, had such income as a result of inheriting several office buildings. Before they were able to arrange disposal of this asset, they realized income and did file a 990T.

Following are two tables which summarize the income and expenses of our agencies in 1985 in greater detail.

TABLE II.1

Income

Source	Number of Dioceses Receiving from Source	Amount	% of Cash Income
Total Cash Income	110	$557,086,643	
United Way	94	$ 50,062,230	9 0
Combined Federal Campaign	10	$ 2,277,058	4
Government Fees and Grants	101	$258,263,540	46 4
Foundation Grants	40	$ 4,821,667	9
Investment Income	76	$ 14,404,014	2 6
Program Service Fees	107	$106,910,128	19 2
Catholic Charities Appeal	51	$ 25,559,000	4 6
Diocesan Grants	82	$ 22,743,593	4 1
Other Contributions	80	$ 26,055,961	4 7
Fundraising	44	$ 8,433,856	1 5
Unrelated Business	27	$ 1,784,312	3
Other	45	$ 35,771,284	6 4
Total In-Kind Income		$ 26,313,856	
In-Kind Salary Contributions	67	$ 14,172,596	53 9
In-Kind Space and Facilities Contributions	51	$ 3,856,677	14 7
Other In-Kind Contributions	45	$ 8,284,583	31 5
Total Cash and In-Kind Contributions		$583,400,499	

TABLE II.2

Expenditures

Category	Number of Dioceses Reporting	Amount	% of Total Disbursement
Direct Program Expenses			
Emergency Financial Assistance	77	$ 26,505,253	5.0
Salaries	95	$221,450,769	41.7
Other	90	$119,110,369	22.4
Unspecified	10	$ 87,111,852	16.4
Total		$454,238,243	85.5
Indirect Program Expenses			
Salaries	84	$ 22,433,970	4.2
Overhead	73	$ 15,557,209	2.9
Other	46	$ 16,093,590	3.0
Unspecified	11	$ 19,657,357	3.7
Total		$ 73,742,126	13.9
Public Relations/Fund Raising	49	$ 3,292,849	0.6
Total Expenditures	108	$535,360,580	

Your subcommittee has asked specific questions relative to nonprofit/for-profit competition in the "same" income producing activities. In response to those (Section I.C. of the Committee release of September 12, 1986.) we wish to state the following:

o If one considers government purchase of services, and fees for services, as income sources, for-profits could and do engage in some of the counseling, adoption and day care activities historically carried on by our agencies. In addition some specific activities authorized by Congress (Section 202 housing, for example), might, if the nonprofit sponsorship requirements were eliminated, be carried on by for-profits. We believe, however, and in many instances governmental bodies agree also, that nonprofit human services organizations provide an economic and social benefit in these areas not easily reproduced by for-profits, especially over time.

So far as our survey indicates, our agencies engage in no activities unrelated to their mission, which are in competition with for-profits.

o As we have just indicated for-profits are increasingly moving into service areas, especially as the private market (non agency adoptions, for example) can provide hefty fees, or as the presence of government direct or indirect expenditures has proved attractive. The tax expenditures for dependent care, for example, are drawing commercial providers, but are also making much more needed care available.

In some of these areas we believe the government, representing all the people, must maintain the option of funding through nonprofit providers, depending on the social outcome sought.

- We see very little (though we do see some) nonprofit activity moving into traditional commercial ventures. In our view this phenomenon has been much exaggerated. We had thought that during recent years, with the government cutbacks, and the repeal of the charitable deduction for non-itemizers, we would be seeing much more of this activity.

  But there is no doubt that nonprofits are in an increasing financial squeeze, and in recent years have been unable to maintain the extent of services provided, say, prior, to 1980. Unfortunately the data seems to suggest that much of the slack has been in services provided to the desperatly poor, as agencies have to rely increasingly on fee for service income.

The subcommittee has asked for a description of change in income since 1950. As has been suggested above, there are no new types of income coming in to Catholic Charities now, as compared to 1950. But obviously there has been a substantial increase in government dollars, and a consequent reach out to serve under-served citizens. Recently we are seeing a dropping off in government funds, a contraction in some service areas, and an increased reliance on fees for service.

We understand that the Subcommittee would like to understand in broad dimensions if and how the relationships between the for-profit and nonprofit sectors have changed over time. On the basis of our observations there has been little nonprofit move into commercial activities, or unrelated activities, but rather a diminution in this type of activity. And we think that several rounds of Congressional amendments have helped this trend. We are much more convinced, however that in the health and human service sectors of our economy, traditionally nonprofit, there has been a significant incursion of for-profits. In this respect, please see our observations above.

Still we share the Subcommittee's desire to understand the consequences of this interaction, and the frustration born of a lack of overall data on which to make an evaluation. We urge that the subcommittee move forward the recommendations and measures designed to improve this data base made by Independent Sector, The Treasury and many other witnesses. In the absence of good data we do not see how any but marginal changes in the law could be made.

(We might observe parenthetically how much our agencies at the local level rely for their governance and as volunteers in the services of local business leaders. No instances of conflict between them have been reported to us.)

One of the key provisions of the law is the relatedness test which would make taxable earned income unrelated to the charitable purpose or mission of an organization. As difficult as this may be to apply in some particular instances, we have heard of no other concept which could be enshrined in law which would not significantly alter the organizational and social landscape of our country. There is a good body of experience around this law, many rulings, and court cases. In the absence of data suggesting the need for a major departure, we urge the Subcommitte recognize the unique work of art the phrase is, and the way in which it can, if properly enforced, act as an appropriate buffer between the nonprofit sector and the for-profit sector, and act to keep nonprofits focussed on their mission.

At the same time those of us in the nonprofit community would welcome an enhanced enforcement program by the Internal Revenue Service. We would also be glad to work with the service in sharpening the attention of our affiliate agencies to the law and its nuances. We hope the Subcommittee directs the Service to work with various subsectors of the nonprofit community.

The Subcommittee asked for a response to the 7 recommendations made by the Department of the Treasury. The experience of our affiliate agencies does not leave us competent to comment with assurance on all of those proposals, but we do our best below. We hope eventually to associate ourselves with other nonprofits, through Independent Sector, and through the National Assembly and the Grants and Contracts Project, in more authoritative comments reflecting a broader experience in the nonprofit community.

- With respect to the relatedness test, we have stated above that we feel it must remain as the lynchpin of the law in granting exemption from tax. However because some small business advocates have been calling for its elimination, and for taxable treatment of nonprofit fee for service and government contract income, we believe the Subcommittee, and the full Committee ought to note the historical tax exempt treatment of these two sources of income and firmly indicate the view that these two sources are not taxable for nonprofit organizations.

  Catholic Charities would support useful more detailed reporting on the 990, as well as disclosure of the formation by a nonprofit of a taxable subsidiary, as well as of another non-taxable entity. We would also support a requirement that an organization's 990, and any relationship between such entities as mentioned above, be available to the public at the main office of the nonprofit for inspection or a reasonable copying fee.

  Further we would hope the Subcommittee and full Committee would direct the Internal Revenue Service to make improvements in the reporting form, and computerize and tabulated the first page of the 990 on an annual basis.

  Independent Sector has made additional recommendations on federal date sources which we fully support.

- Catholic Charities agencies themselves do not seem to make much use of the convenience exceptions to UBIT, but we do think that some forms of convenience exception are required in some circumstances, as in the absence of a stable commercial provider able to provide the service in a way which does not disrupt the functioning of the agency.

- We agree with the Treasury that allocation experience between tax exempt and related for-profits should be studied carefully, and very clear allocation rules published. We support the retention of the fragmentation rule and the Treasury's proposal that the deduction from unrelated business income be raised from the current $1000.

- We do not believe the passive income of 501(c)(3) organizations ought to be taxable, but the experience of our agencies gives us no basis for comment on the Treasury's recommendation on the relationships to controlled subsidiaries.

- The provision on exclusion from tax for income derived from certain research activities is beyond the experience of Catholic Charities agencies.

- To our knowledge organizational forms in Catholic Charities do not involve any joint ventures, and so we cannot comment on the problem the Treasury raises with respect to the allocations in a partnership situation.

As a final note we wish to comment briefly on the Subcommittee's observation that the size of the nonprofit sector has grown quite a lot. This is not surprising, and should not be a source of consternation. We believe that if you look at the available data over time it will be obvious that the nonprofit sector has grown as our economy has grown, and not out pace, by and large, with other sectors of the economy. It has grown, or some subsectors of it have, as a result of government policy extending the human services and health care to larger segments of the population. It has grown as new populations have become absorbed in our country and have organized their own voluntary associations. And at least part of the growth is deceptive, since it merely reflects a change of policy on reporting; there are a large number of human service nonprofits which were not required to file a form 990 until Treasury clarified the meaning of the term "integrated auxiliary" added to the Internal Revenue Code in the 1969 amendments. Finally, we might add, we would rather see the nonprofit sector grow in its provision of human services, than to see our nation develop a government system to deliver those services.

We want to express our appreciation to the Subcommittee on Oversight for undertaking this important inquiry, and state our interest to work with you and your staff in the months to come.

Elfreda Christensen
Hearing Aids

622-8312
623-1314
Area Code 714
P.O. Box 2190
Pomona, California 91769
788 North Garey Avenue
Pomona, California 91767

June 10, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
Longworth House Office Building
Room 1102
Washington, DC 20515

RE: Commercial activities by tax-exempt organizations-
Unfair to Hearing Aid Specialists

1. Non-profit organizations should not be allowed to sell hearing aids. These tax-exempt organizations are unfair competition to the small business industry of selling and servicing hearing aids which helps support these non-profit organizations.

2. Unfair competition created by the public schools that employ audiologists for hearing tests paid for with taxpayer's money and then provide captive business for the audiologists selling hearing aids. This is unfair and should be considered unethical.

3. The Hearing Aid Industry was created by the dedicated tax paying Hearing Aid Specialists and should be protected from the spread of unfair competition by the non-profit hospitals, clinics, et al.

Respectfully,

Elfreda Christensen R.N. HAD #8
Elfreda Christensen

COOK-WITTER
INCORPORATED

July 24, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways and Means Committee
2111 Rayburn Office Building
Washington, DC 20515

Dear Congressman Rostenkowski:

Bob Cook and I represent a number of statewide associations as well as being members of the Chicago Society of Association Executives and the American Society of Association Executives. All of these groups may be affected by the Unrelated Business Income Tax (UBIT) proposal which is presently being considered by the House Ways and Means Committee.

We understand that one part of the proposal is the taxing of the investment income of trade associations and taxing the passive income (e.g., royalties, interest and dividends) of all tax exempt organizations. We encourage you not to support this change because many trade associations rely on such incomes to balance an already tight association budget of their own.

Next, it is our understanding that investment income is targeted with a proposed 5% excise tax applied to all corporations or trusts tax exempt under the internal revenue code. We understand that the argument is that any group benefiting from federal funds should help reduce the budget deficit. However, the excise tax being proposed would raise some $15 billion over two years -- this seems quite inequitable when compared to other revenue sources.

Finally, we understand that there is an additional proposal reducing the deduction for business meals and entertainment to 75% or possibly even 50%. This proposal would generate somewhere in the neighborhood of $1.3 to $6.6 billion which again we believe is an inequitable means of generating additional revenue.

While almost all associations are sympathetic with an attempt to balance the federal budget by generating more revenues, we believe in so doing that all levels of our society should be held responsible to bear the burden to some extent. An overly burdensome tax on the association community is unwarranted. We encourage you to give do consideration to the method as well as the outcome of additional changes to tax exempt organizations.

Sincerely,

Randall F. Witter

Randall F. Witter
Cook-Witter, Inc.

RFW:gc

625 S. SECOND STREET • SPRINGFIELD, ILLINOIS 62704 • 217/789-6252

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD

TREATMENT OF LOAN COMMITMENT FEES - AN ANOMALY IN THE UNRELATED BUSINESS INCOME TAX

BACKGROUND

An employee pension trust ("pension trust") holds and invests funds on behalf of its pension plan beneficiaries. If the pension plan meets the requirements of section 401 of the Internal Revenue Code of 1986 (the "Code"), then the plan will be considered "qualified" and generally the pension trust's earnings will be exempt from taxation. (See section 501(a) of the Code.)

The primary purpose of a pension trust is to maximize the appreciation of its assets. However, consistent with the duty of a trustee, the pension trust bears a fiduciary responsibility to conserve the pension plan's assets. The pension trust can engage in only prudent, conservative investments. Unlike other tax-exempt organizations (which are granted a "substantially related" exception), pension trusts cannot earn exempt income from participation in any active trade or business and can engage in only passive investment activities. (Section 513(b) of the Code.)

Pension trusts, like other tax-exempt organizations, are not allowed to earn exempt income from activities that are unrelated to their tax-exempt purpose. Section 511 of the Code subjects such income to an unrelated business income tax ("UBIT"). Unrelated business taxable income ("UBTI") is subject to the UBIT and is defined by the Code as income that is both (1) derived from a "regularly carried on" trade or business and (2) "substantially unrelated" to the tax-exempt purpose of the organization.

Section 512(b) of the Code enumerates several "modifications" to the UBIT which exclude certain types of investment income from taxation. Specifically excluded is traditionally passive investment income such as interest, rents, royalties and gains from the sale or disposition of capital assets. Congress believed that these types of investment income "are `passive´ in character and are not likely to result in serious competition for taxable businesses having similar income." S. Rep. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).

A problem arises for tax-exempt organizations because whether certain types of investment income earned in conjunction with the loaning of funds constitute UBIT is subject to varying interpretations under existing law. The following discussion examines the treatment of income generated from non-refundable commitment (or guarantee) fees that arise when funds are reserved for a borrower for a specific time period.

COMMITMENT FEES

In general, commitment fees are non-refundable charges made by a lender to reserve a sum of money with fixed terms for a specified period. Usually, the reservation period is relatively short--90 days or less. These fees are typically charged primarily to compensate the lender for the risk it undertakes in committing its funds and for the alternative investment opportunities it must forego because of its commitment.

No authority directly addresses whether *commitment fees* are subject to the UBIT, although the Internal Revenue Service (the "Service") has taken the position that *service fees* for legal, closing, appraisal and accounting costs incurred in conjunction with a loan are UBTI because they do not qualify as interest. Rev. Rul. 79-349, 1979-2 C.B. 233.

The relevant authorities regarding commitment fees focus primarily on the issue of whether a *borrower* should deduct, or amortize, commitment fees in a given situation. For example, where a loan is consummated, the Service and the courts have treated commitment fees like interest and required taxpayers to amortize the fees ratably over the life of the loan. *See, e.g., Francis v. Commissioner*, 36 T.C.M. (CCH) 704 (1977). Where no loan is made, however, taxpayers have been allowed to deduct the fees as an ordinary and necessary business expense under section 162 of the Code.

The Service has also taken the position that commitment fees are "similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option." Rev. Rul. 81-160, 1981-1 C.B. 312, 313. If the "option" is exercised, "the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan." *Id.* Nevertheless, contrary to the result of Revenue Ruling 81-160, section 512(b)(5) excepts from the UBIT "all gains on *the lapse or termination of options*," as well as any gain from an exercised option (as capital gain attributable to the underlying stock).

Whether commitment fees are subject to the UBIT is subject to varying interpretations under existing law. If treated like options, it would be appropriate for commitment fees to be exempt from the UBIT under section 512(b)(5) regardless of whether a loan were consummated. On the other hand, if treated like interest, the Service might take the position (under the rationale of Revenue Ruling 81-160) that commitment fees would be excluded from UBTI only if a loan were consummated.

Commitment fees should be exempt from the UBIT regardless of whether they are treated like options or interest, and irrespective of whether a loan is consummated. Commitment fees represent activities that are more passive and less subject to risk than such sanctioned income as interest and the gain from stock options. The receipt of interest from a secured loan is an acceptable passive activity presumably because it entails relatively minimal risk or active business involvement on the part of a tax-exempt organization. Yet, once a loan is made, the lender bears both the risk of default and the responsibility to properly service the debt. Similarly, managing stock options requires substantial attention and is inherently riskier than merely collecting dividends on the underlying stock. The reservation of money represented by commitment fees, however, entails no direct risk (since the funds are still in the possession of the lender) and involves less managerial attention. The commitment fee primarily reflects the costs of evaluating the investment opportunity and potential lost opportunity costs.

Tax-exempt organizations may also earn exempt investment income by loaning securities to brokers. (Sections 512(b)(1) and 512(a)(5) of the Code). An exempt trust that lends its securities to a broker foregoes the dividends and interest that its stocks and bonds would generate. In turn, the broker compensates the exempt organization for its foregone income by paying a fee which is considered to be exempt income. A prospective borrower is engaged in a similar exercise when it compensates the exempt organization that reserves funds for a potential loan, since a trust must forego other passive investment opportunities while the borrower decides whether or not to proceed with a particular loan.

THE REIT PARALLEL

Amending section 512(b) to make clear that commitment fees are not subject to the UBIT would be consistent with analogous provisions of the Code. Under sections 856(c)(2)(G) and 856(c)(3)(G) of the Code, commitment fees are qualifying income (regardless of whether a loan is consummated) for purposes of determining whether an entity is a real estate investment trust ("REIT"). In order to qualify as a REIT, among other requirements, 95 percent of an entity's gross income must consist of certain types of passive investment income such as commitment fees. (Section 856(c)(2) of the Code.) Similar to the policy underlying the UBIT, the purpose of this requirement is to ensure that a REIT is a passive investor and not an active competitor with businesses that do not receive the tax benefits afforded REITs. Moreover, some types of passive income exempt from the UBIT are even defined in terms of the analogous REIT rules. See section 512(b)(3) of the Code (rents); Reg. § 1.512(b)-1(c)(2)(iii)(b) (cross-referencing to the REIT rules for purposes of determining qualifying rents). Thus, the REIT provisions clearly support an amendment to section 512(b) which would specifically exclude commitment fees from UBTI.

CONCLUSION

The UBIT rules are designed to limit unfair competition from exempt organizations by distinguishing between passive investments and potentially competitive activities. The application of these rules to a pension trust has created some artificial distinctions that affect the ability of these funds to manage their investments in a prudent, conservative manner.

A pension trust exists to maximize benefits responsibly for its covered employees and their beneficiaries. Because a pension trust's investment activities must be confined to investments that are consistent both with its fiduciary responsibility and the provisions of section 512(b), a pension trust's alternatives are narrowly confined. The policy underlying the investment activities of a pension trust thus is driven more by a sense of fiduciary responsibility than a desire to compete with taxable entities.

Sound public policy demands that tax-exempt organizations be able to anticipate potential tax liabilities. The existing law, however, makes it impossible for a pension trust to project the tax consequences of all its actions in making a loan commitment. Although the making of loans by a pension trust is a statutorily sanctioned activity, the pension trust's tax liability for commitment fees is unclear under current law. Because the earning of commitment fees is an inherently low-risk, passive activity that represents a conservative strategy for a pension fund to ensure the appreciation of its assets, section 512(b) of the Code should be amended to provide that commitment fees are not subject to the UBIT.

PROPOSAL

Section 512(b) of the Code should be amended to make clear that commitment fees are not subject to the UBIT. The following suggested language would accomplish this objective:

> Subsection (b)(1) of section 512 of the 1986 Code (relating to modifications to unrelated business taxable income) is amended by striking out "interest" and inserting in lieu thereof "interest, including fees relating to the securing, processing or commitment of a loan (regardless of whether or not the loan is made)"

# # #

Drake Hearing Aid Center
3124 NORTH TENTH STREET
ARLINGTON, VA. 22201
(703) 528-2021

TIMOTHY L. DRAKE
President

H. DANIEL DRAKE, JR.
Lifetime Association with the Deafened
Founder

July 14, 1987

Dear Chairman Pickle,

As a Hearing Aid Dispenser and a small businessman, I would like to register my discontent with the present laws concerning Non-Profit Corp.. There exists very great unfair competition and tax loss. In the Washington, D.C. market, I have lost many well-to-do customers, who need no charity, to several local Non-Profits. Because of this, I am unable to hire an extra person, the Federal, Maryland, Virginia, and local governments have lost taxes.

Non-Profit corps. are unnatural businesses in a society of tax payers. They were allowed originally as exceptions only because certain goods and services were not available ANY OTHER WAY. This was their reason to exist. I support this reason to exist, but when a For-Profit can exist and provides these same goods and services, then this reason to exist is no longer valid. If then, the Non-Profit is allowed to contiue in the same market, an obvious unfair competition inhibits the advance of society through the unnecessry loss of taxes postal fees, frustration of normal legitimate business efforts, and misdirected heart-felt donations.

I believe that a great deal more in costs and tax losses are lost than is suggested. I believe that,if profit centers were spun off,then padded areas would be turned into profits.

The Hearing Aid For-Profits in D.C. have felt unfair competition from several Federally supported hospitals and universities. These are the Washington Hospital Center, Gallaudet University, and the University of Maryland. Other Non-Profit competitors are Washington Hearing and Speech Society and Easter Seal Society. These represent a loss of about 1/3 of my gross income in each of the past 4 years. This is quite sizable! They do this by encouragement with lower prices from lower cost mail advertising, no taxes on inventories or property, and bogus infuence for donations.

When a Non-Profit has a profit center or when a For-Profit emerges, it is almost imposible for the For-Profit to have the Non-Profit's tax status changed. It must appeal to the IRS to acquire their books and to define what profits are. This is a monumental and frustrating task for the small businesses. This process must be streamlined.

I suggest that the assumptions be reversed. Since the Non-Profit is the unnatural exception, it should have the onus to prove that its reason to exist is still valid. The For-Profits should be able to appeal to the IRS easily. Instead of a complicated explanation of profitability, it should only need to attack the Non-Profit's reason to exist; that is, that a For-Profit could not be able to provide the same goods or services. If the For-Profit can prove that it can,then it should be assumed that unfair competition exists and that tax money is being lost. The profit center should be displaced or spun off. The Federal Government must recognize that the economy changes and that changes in these unnatural franchises must reflect these changes. (We do not want an economy of "fireman on diesel trains".)

In order fot the Non-Profits to legally exist, they should not have a profit center that competes with a For-Profit. Whether this profit center is related business or not is irrelevent! They should be spun off as a separate corporation. This separate corp. should not be owned by a Non-Profit nor should it own a Non-Profit or be a part of an umbflla organization which has a Non-Profit within it. This new For-Profit spin-off can be self supportive or owned by another For-Profit. These points are important because of the following:

A. Rents can be made high enough to siphon off the profit to the Non-Profit, rendering them both non-taxable.
B. Employees could be shared and the Profit maker could be made to pay a disproportionate amount.
C. Reduced insurances and other advantages could easily be improperly shared.
D. The For-Profit could be expected/forced to "donate" a high percentage of its profits.
E. Monies and loans could loosely be shifted both ways to relieve cash flow problems and increasing competition.
F. Advertising and the unsupported assumption of shared high ethical standards and a sense of a charity status.
G. Property taxes would be lost,if the For-Profit is located on the same campus or land.

Having been invited to participate myself in an umbrella operation owned by a Non-Profit, I know that these seven activities do exist and that there is no way for the IRS to discover them. Therefore without separating a Non-Profit from any corp. association with a For-Profit, neither fair competition nor proper tax revenues can be known or changed from the present. Both could be rendered profitless and it will be business as usual!

The tax loss is much greater than what the Non-Profits will report or the IRS can speculate. The unfair competition, especially from government organizations is repulsive and very great to many industries; the Hearing Aid Industry. I believe that the American people would much rather have these unnatural organizations either cease their competitive operations or pay taxes after they are spun off rather than have the imbalanced budget remain or have their own taxes raised.

Please change the tax laws soon.

Sincerely,

Timothy L. Drake

Timothy L. Drake
NBC-HIS #1400

Erie Audiology & Hearing Aid Center

2616 West 8th Street, Colony Plaza, Erie, PA 16505
814/833-9533

June 12, 1987

Robert J. Leonard, Chief Counsel
Ways and Means Committee
U. S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D. C. 20515

Dear Sir:

As a small businessman in the taxpaying sector of the American economy I would like to comment on the tax exempt hospitals entering into competition with the paying businesses. As you can see from my stationary I am an audiologist and hearing aid dealer/fitter. In the small city of Erie, Pennsylvania there are currently nine hearing aid dealers employing many people and paying taxes to support our country. One of the hospitals (550 bed), which is tax exempt, has begun dispensing hearing aids. Another tax expempt hospital of the same size in this same small city will be dispensinghearing aids by fall of this year.

I am all for fair competition between individuals or groups in the taxpaying sector, but am opposed to the unfair advantage of the tax exempt in entering my field of endeavor. My tax money is being used to help support programs paying for health care. I feel those programs are nessary to help treat the indigent and elderly, but, indirectly, the monies are being used to support a business (hearing aid dispensing) which is in direct competition with myself. I am sure you can see the irony of this situation.

I would like to recommend that the House of Representatives take a strong stand in support of the small businessman by stopping the tax exempt institutions from participating in provision of services already being provided by taxpaying individuals or groups. This limitation will surely not hinder these multi-million dollar operations, but allowing them to continue in the private sector of the economy could definitely hurt those of us in the low six figure gross operation. The continuance of the tax exempt institution in the private sector could cause loss of employment and tax revenue. I am sure you agree that this is not, nor was not, the purpose for granting the tax exemptstatus in the firstplace.

Thank you for your consideration.

Sincerely,

Neal E. Mann

Neal E. Mann, M.A.,C.C.C.
Licensed Audiologist
Registered Hearing Aid
Dealer/Fitter

NEM:dss

**Florida Chiropractic
Association, Incorporated**

217 N. Kirkman Road, Suite One, Orlando, Florida 32811
Telephone (305) 290-5883

ED WILLIAMS, D.C.
Executive Vice President

June 23, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
2111 Rayburn House Office Building
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Those of us who have chosen a career in association management are extremely concerned about the proposals of the Joint Committee on Taxation which would apply the unrelated business income tax to certain types of income of trade associations and other tax-exempt organizations.

Representatives of the association industry testified before the House Ways & Means Oversight Subcommittee last week, so I won't reiterate our extensive opposition to the proposals in this letter. My immediate concern is that your Committee, in its zeal for finding new sources of revenue, might make inappropriate or ill-considered changes in the applicability of the unrelated business income tax.

The Oversight Subcommittee has conducted an extensive review of the statute, and I urge you to exercise the power of the Chair to insure that the findings and recommendations of that sub-committee are given full consideration before the Committee takes further action on this issue.

Respectfully,

Ed Williams, D.C.
Executive Vice President

ECW:dm

cc: FCA Board of Directors

FLORIDA HOSPITAL ASSOCIATION, INC./BOX 536905, 307 PARK LAKE CIR., ORLANDO FL 32853-6905 305/841-6230

July 24, 1987

The Honorable Dan Rostenkowski
Chairman, House Ways & Means Committee
2111 Rayburn House Office Building
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Those of us who have chosen a career in association management are extremely concerned about the proposals of the Joint Committee on Taxation which would apply the unrelated business income tax to certain types of income of trade associations and other tax-exempt organizations.

Representatives of the association industry testified before the House Ways & Means Oversight Subcommittee last week, so I won't reiterate our extensive opposition to the proposals in this letter. My immediate concern is that your Committee, in its zeal for finding new sources of revenue, might make inappropriate or ill-considered changes in the applicability of the unrelated business income tax.

The Oversight Committee has conducted an extensive review of the statute, and I urge you to exercise the power of the Chair to insure that the findings and recommendations of that subcommittee are given full consideration before the Committee takes further action on this issue.

Respectfully yours,

Wade H. Edwards
Vice President

Charlie Gillum
UNITED
Hearing Aid Service
628 Commercial
Emporia, KS. 66801
(316) 343-1100

Member
National Hearing Aid Society

June 9, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means, U.S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Sir:

I am a hearing aid audiologist who has been making my living by testing, fitting, and servicing hearing aids in the State of Kansas since 1967. I have always had to work hard and be very competitive to have an income that filled my obligations for raising my family. In the last three years I have run into a problem that I feel is very unfair competition that I have not been able to compete with. That problem is that I have another man and now a lady who covers about the same territory I do. Although they only come to town once or twice a month I estimate that they have taken half of my business. They do this by going into the hospitals, using their facilities and surrounding themselves with a medical atmosphere. In many cases the people feel that they are doing business with a doctor who is a hearing specialist. I feel that I should not have to compete with any tax free organization. Although the following doesn't all affect me it is happening in our state at the present time. If a non-profit organization, especially hospitals are allowed to continue this practice such as restaurants, drugs, hearing aids, answering services, laundry facilities, and etc. we will find more of our businesses shut down. I do not think this makes for a healthy economy. I feel a lot of the hospitals have a big adjustment to make and that is because they have had to much easy money in the past and have over extended themselves.

In closing I would just ask you to please help to let America's free enterprise system work. We can do this by keeping everything competitive and fair.

Very truly yours,

Charlie Gillum

CG:lm

STATEMENT OF GOODWILL INDUSTRIES OF AMERICA, INC.

GOODWILL INDUSTRIES OF AMERICA, INC. (GIA) appreciates the opportunity to submit this statement in response to the Subcommittee's comprehensive review of the federal tax treatment of unrelated business income (UBI) and other income-producing activities of organizations that have tax-exempt status under Section 501 of the Internal Revenue Code.

We believe the key issue which must be addressed by this Subcommittee can be expressed as follows: Does the granting of tax exemption produce measurable contributions to the public good that exceed the cost to the government or to the private sector of foregoing the tax? Congress for many years has recognized that the small amount of lost revenue resulting from the granting of tax exemption is more than compensated for by the contributions to the public good in the national interest. GIA asserts that the conditions on which Congress based this decision remain fundamentally unchanged. This statement will show that not only are allegations of "unfair competition" overstated, but objective, quantitative analysis demonstrates that any economic advantages available to Goodwill Industries through its tax exemption are offset by the provision of human services which significantly contribute to the general good of society.

GIA is a national nonprofit corporation, tax-exempt under Section 501(c)(3) of the Code, serving individuals with disabilities and others with special needs through 176 member vocational rehabilitation facilities in North America and 44 affiliates in 30 countries outside North America. GIA's mission statement provides that:

> Goodwill Industries will actively strive to achieve the full participation in society of disabled people and other individuals with special needs by expanding their opportunities and occupational capabilities through a network of nonprofit, community-based organizations operating throughout the world in response to local needs.

Each of these 176 autonomous, community-based, nonprofit organizations in the United States, which are also tax-exempt under Section 501(c)(3), provide a variety of vocational rehabilitation services to individuals with disabilities and other barriers to employment, including job training, vocational evaluation, transitional employment, independent living skills, career counseling, and private sector placement assistance. For individuals with severe disabilities for whom a job in the competitive market is not a realistic expectation at their present level of training, Goodwill Industries provides paid employment sometimes in a structured, "sheltered" environment in accordance with the special wage provisions of the Fair Labor Standards Act. Goodwill serves individuals with a broad range of vocational disabling conditions, with mental retardation the largest single category of primary disability.

DEPARTMENT OF TREASURY RECOMMENDATIONS

Following the testimony of Deputy Assistant Treasury Secretary O. Donaldson Chapoton to the Subcommittee on June 22, the Chair requested all organizations submitting material to the Subcommittee to respond directly to the seven initial observations and recommendations contained in that statement. Goodwill's responses follow:

Recommendation #1: Goodwill Industries strongly agrees with Treasury that the current "substantially related" standard to determine whether nonprofit organization's revenues are exempt from income tax has conceptual merit and should be retained. Testimony presented during the Subcommittee's hearings by some representatives of the for-profit sector advocated replacement of the substantially related test with a "commerciality" or "competition" standard.

The problem with such an approach from GIA's perspective is that many of our employment and training activities, such as janitorial and fast food programs, could be described as "commercial" in nature, but their purpose is to train individuals in work skills that will enable them to gain entry into the job market. Thus, the activity is "substantially related" to our exempt purpose, but might fail to qualify for exemption under a strict "commerciality" test.

We agree with Treasury's assessment that "efforts should focus instead on obtaining more detailed information concerning the revenues of exempt organizations and the basis for treating them as tax exempt." A review of the description of Goodwill's activities provided below clearly indicates that a radical move away from the substantially related test would seriously undermine Goodwill's ability to provide vocational rehabilitation services to people with disabilities and other barriers to employment so that they may become taxpayers rather than tax users.

We further support Treasury's proposal to require more detailed reporting of income-producing activities as a means of improving compliance and enforcement. As a membership organization comprised of autonomous local organizations, GIA does not exert financial control over our members and does not file a combined financial report for all our members. Therefore, we do not receive or have access to the type of financial data of our members that enables us to report on the amount of unrelated business income tax paid by our local members. Especially in light of this type of arrangement for national membership organizations, it would not be unreasonable for nonprofit organizations to be required to report on Form 990 income sources along with the justification for tax exemption for each of those sources.

Collecting this data would produce two benefits. First, nonprofit organizations each year would be required to examine their income-producing activities to determine if income derived meets the substantially related test, or falls within the specific exemptions from unrelated business income tax. This annual "self-assessment" would, we believe, enhance compliance with current UBI regulations because nonprofit organizations would be required to be knowledgeable of present law and regulation as a condition to completion of Form 990. As a national organization, Goodwill Industries of America recognizes its obligation to undertake efforts to educate our members on their compliance responsibilities, and we have provided our members with a video instruction tape outlining UBI compliance requirements. This tape has been distributed to nonprofit vocational rehabilitation facilities outside of the Goodwill network as well as other human service organizations.

Second, data collected as part of this self-assessment effort would permit the Internal Revenue Service to monitor dollar amounts generated and identify trends in income-producing activities for the entire nonprofit sector and its several sub-sectors. This information would enable the Service to utilize its enforcement resources more effectively by targeting specific types of income-producing activities and/or the organizational justification of those activities for closer examination.

Recommendation #2: Goodwill members' limited experience with activities performed for the convenience of employees is primarily restricted to the operation of cafeterias. A description of these operations is provided in the following text. As can be observed from that description, these activities are substantially related to our exempt purpose and as such the revenues gained, if any, are defensible as being tax exempt. We do not have sufficient experience to comment on the Treasury recommendation concerning activities conducted solely on the grounds of convenience for employees, etc.

We do, however, have considerable experience with the exemption provided for sales of donated property. We strongly agree with Treasury's assessment that taxing the income generated through the sale of donated property "would generate little, if any, taxable income, and that the exception is justified on grounds of administrative convenience." As noted in the revenue source table below, Goodwill's sale of donated clothing and other items, along with sales of material (salvage) unsuitable for resale to the public, provides the largest portion of revenues used to run our vocational rehabilitation programs. Elimination of this exemption would greatly restrict our ability to offer rehabilitation services and might well cause many Goodwill members to cease operations.

There is, however, one issue related to the donated goods exemption which we believe merits examination by the Oversight Subcommittee. The income produced by our sale of donated goods is exempted from the definition of unrelated business income. Similarly, income generated by nonprofit organizations from royalties is also exempted. We are aware of situations where a nonprofit organization has "contracted out" the collection and sale of donated goods (which are tax deductible for those individuals who itemize their returns) to a for-profit firm for which the nonprofit organization is paid a royalty for the use of its name. We believe that this type of arrangement violates the spirit of the law, because individuals making a donation to the nonprofit organization are under the false assumption that their contribution directly benefits the charitable organization to whom the donation is made. In fact, only a small portion (often 10 percent or less) of their donation supports a charitable cause and the donor/taxpayer unwittingly is subsidizing a large, profit-making enterprise.

Although we hesitate at this time to make a specific legislative recommendation as to how this situation can be resolved, we believe the issues raised by this type of arrangement deserve further examination by the Oversight Subcommittee, especially in light of Treasury's concerns about the broad scope of the passive income royalty exception (Treasury recommendation #5). We would be pleased to work with the Subcommittee staff on creating a solution to this problem which protects the legitimate right of a nonprofit organization to generate royalties from the use of its name while avoiding the unethical situation described here.

Recommendation #3: Clarification of the rules for allocating expenses between exempt and unrelated activities appears to be a desirable goal, although neither GIA nor our members can cite specific problems or suggest possible remedies. Treasury's recommendation that the "specific deduction" be increased to $5,000 from $1,000 is justified, we believe, since the deduction has not been increased since 1950.

Recommendation #4: Goodwill does not have sufficient experience in the issues raised here to comment on Treasury's recommendation to broaden the definition of a "controlled subsidiary" and to aggregate the activities of a tax-exempt organization and its subsidiaries for the purpose of granting tax-exempt status.

Recommendation #5: The small amounts of passive income generated by local Goodwills are used to support our vocational rehabilitation programs, and accordingly, we agree with Treasury's assessment that this income remain exempt from taxation for public charities. As referenced in our discussion on Treasury recommendation #2, it may be advisable to narrow the definition of royalty to preclude the abuses of the donated property exemption. Such a change in the definition would have to be carefully drafted.

Recommendation #6: The research demonstration activities conducted by GIA, generally in conjunction with local members, are normally funded through federal government grants which are usually matched by Goodwill funds. Typically, these research demonstration projects test alternative methods of rehabilitation service delivery, with the goal of determining cost effective vocational methods of training and placing individuals with disabilities into competitive, private sector jobs. For example, GIA recently was awarded a $150,000 grant from the Office of Human Development Services in the Department of Health and Human Services to develop and implement an innovative approach to the employment and training of individuals with developmental disabilities. This project will focus on the utilization of service clubs (Lions, Rotary, Jaycees, etc.) to promote the hiring of people with developmental disabilities after training by Goodwill. We anticipate that at least 75 individuals with disabilities will become employed as a result of this project, which should become a pilot program leading to the employment of several hundred persons annually. We believe that to alter the definition of research activities in any way that would reduce Goodwill's ability to engage in these types of activities would be short-sighted and ultimately lead to greater government expense.

Recommendation #7: We are not aware of any local Goodwill engaged in joint venture activities, and therefore, we reserve comment on this recommendation.

GOODWILL'S OPERATIONS AND REVENUE SOURCES

To generate revenues to support the provision of vocational rehabilitation services, each local Goodwill solicits and collects donated items from individuals and for-profit businesses, processes the items in a variety of ways, then sells the useful objects in retail outlets at a mark-up sufficient to cover costs of collection, overhead and value added in processing. Individuals with disabilities are extensively involved in all facets of this "donated goods" process, gaining valuable work experience and training. On average, approximately 54% of operating revenues are generated through Goodwill's donated goods program, which are exempt from taxation of UBI under the donated property exclusion.

Goodwills provide vocational rehabilitation services on a fee-for-service basis to federal, state and local government agencies and insurance firms. It must be emphasized that the individuals who receive these rehabilitation services from Goodwill Industries are not charged -- all services are provided at no cost to the individual despite the fact that the state/federal fees received are actually less than 20 percent of the costs incurred. The major source of payment for these fee-for-service arrangements is state vocational rehabilitation agencies, which are primarily funded through federal grants (80%) under the Rehabilitation Act of 1973 and supplemented by state appropriations (20%). Fees generated by the provision of these services are considered to be exempt from UBI taxation because they are substantially related to Goodwill's charitable mission.

Goodwills also perform industrial and service contracts for for-profit businesses. Again, individuals with disabilities perform most or all of the tasks necessary to meet the requirements of these industrial and service contracts. This aspect of Goodwill's operations will be discussed in greater detail below.

The balance of operating revenues is derived from charitable contributions and government matching grants to support demonstration and research. Any earned revenues in excess of expenses are used to increase Goodwill's capacity to meet local community needs through expanded vocational rehabilitation services to individuals with disabilities.
The following table lists aggregate revenue sources of the Goodwill Industries network for 1986:

ACTIVITY	AMOUNT (in millions)	PERCENT OF REVENUE
Retail sales of donated goods (includes salvage sales of unusable items)	$243.2	54.4%
Fees for rehabilitation services	72.4	16.2
Industrial and service contracts	57.6	12.9
Public support (other than donated goods)	41.9	9.4
Government grants	15.1	3.4
Miscellaneous	16.6	3.7
TOTAL	$446.8	100.0%

Included in the "miscellaneous" category are activities such as food service operations and dormitories. These activities are substantially related to Goodwill's charitable mission. For example, cafeterias are at times operated by local Goodwills exclusively for clients and employees as a source of low-cost, nutritionally balanced meals. In a few other cases, cafeterias are open to the public and are a source of nutrition for senior citizens and other special groups. In both instances, the food service operations, staffed by individuals with disabilities, are an integral part of Goodwill's vocational rehabilitation program. Similarly, some Goodwills operate dormitories for short-term residents who are participating in vocational training programs, while others operate long-term residential facilities, usually for individuals with severe disabilities. Fees paid for use of these dorms and residential facilities come from the residents, who are in turn sometimes subsidized through state vocational rehabilitation agencies, welfare programs, or the Department of Housing and

Urban Development. It must be noted that expenses in the miscellaneous category exceed revenues by 0.8 percent. Thus, the income-producing activities included in this category are not undertaken with any "profit-oriented" motive and usually result in negative cash flow.

Goodwill Industries is the largest network of privately operated vocational facilities in the world. In 1986:

- 82,149 individuals were served in Goodwill vocational rehabilitation programs.
- 48,159 people with disabilities were employed in Goodwill facilities, retail outlets, and industrial and service contract programs.
- 12,990 individuals were employed in competitive, private sector jobs as a result of Goodwill placement services.

From our perspective, the Subcommittee's inquiry into the tax status of nonprofit organizations, and more specifically, taxation of unrelated business income occurs at an appropriate time for several reasons. First, there has been no comprehensive Congressional review of the unrelated business income tax rules since the revisions included in the Tax Reform Act of 1969. The changing scope and nature of the nation's nonprofit sector in the intervening 18 years provide ample justification for the Subcommittee's inquiry. We also recognize that Congress faces a difficult task in raising revenue to reduce the federal deficit while at the same time preserving the "fairness" of the tax code. Goodwill Industries seeks to assist this process by contributing to the tax base through the employment and job placement of individuals with disabilities, and by saving scarce fiscal resources that otherwise would be consumed by public aid payments to people with disabilities, who without our help would never become self-supporting and socially independent.

Second, GIA has initiated a long-range planning effort to define its corporate goals, and strategies to meet those goals, in the remaining years of this century. Congressional consideration of new or revised tax code provisions, as a result of the Subcommittee's hearings, which may affect Goodwill's ability to provide vocational rehabilitation services to individuals with disabilities must be an integral part of our long-range planning process.

Third, certain associations of small business operators are raising allegations that nonprofit organizations, as a result of their exemption from federal income taxes and other preferential treatment, have an "unfair" competitive advantage in the market place over some for-profit concerns. While specific complaints from the small business sector critical of Goodwill Industries' operations have infrequently occurred, we believe these allegations must be examined, and wherever possible, resolved. Resolution of these complaints -- whether real or based on an inaccurate perception of the operation and role of Goodwill Industries in our society -- is of utmost importance to the Goodwill network given the mutually beneficial relationship which has existed for many years between Goodwill Industries and the for-profit small business community. The elements of this unique relationship will be discussed in greater detail below.

As a result of these factors, GIA in January of this year sought an independent analysis (prepared by the Santa Fe Corporation of Alexandria, VA) of the issues raised by portions of the small business sector in an effort to answer the following questions:

- Does Goodwill compete with the for-profit sector?
- Is the competition "unfair"?
- Is the competition harmful to the national interest?

Answers to these questions are included in Goodwill's study, Evaluating the Issue of Alleged Unfair Business Competition Between Goodwill Industries and the For-Profit Business Sector, a copy of which has been provided to the Subcommittee staff.

During the five days of Subcommittee hearings on this issue, considerable attention focused on the lack of reliable data on the activities of nonprofit organizations and the relationship of these activities to the for-profit sector. It is especially important to note, therefore, that this study provides a detailed objective examination of the "unfair competition" issue under consideration by the Subcommittee from the perspective of nonprofit vocational rehabilitation facilities.

Answers to each of these questions are provided as they apply to the industrial and service contracts performed by local Goodwill Industries and utilized in the job training and vocational rehabilitation programs assisting individuals with disabilities. The study analyzes Goodwill operations in three categories of industrial and service contracts: packaging, custodial maintenance, and printing and related services.

To our knowledge, the other major income-producing components of a typical Goodwill -- retail sales of donated goods, fees for vocational rehabilitation services paid under third-party reimbursement arrangements, and sales of salvage material -- have not generated complaints of unfair competition from for-profit businesses, nor has it been suggested that the income generated by these component operations be characterized as unrelated business income because of their fundamental link to Goodwill's charitable mission.

DOES GOODWILL COMPETE WITH THE FOR-PROFIT SECTOR?

An examination of Goodwill operations will support the conclusion that we conduct a variety of lines of business which are also conducted by for-profit entities. Such a cursory examination, however, does not reveal the degree to which similar lines of business are conducted in the same market area. The fact that Goodwill may provide custodial services in San Diego does not constitute competition to a for-profit business in Kansas City.

This market-by-market comparison becomes even more important given the autonomous nature of the Goodwill network. Each Goodwill facility provides vocational services to meet a clearly identified community need that in all likelihood would not be met by either federal, state, or local governments, or the for-profit sector in Goodwill's absence. At times, a for-profit entity may enter a market in a similar line of business subsequent to Goodwill, or in order to provide training opportunities for its clients, a local Goodwill may undertake activities somewhat similar to a small business's operations, with some competition resulting. With this understanding, it is correct to say that some competition exists between some Goodwill operations and some for-profit businesses in local markets.

IS THE COMPETITION "UNFAIR?"

By describing the limited competition which exists between the two sectors as "unfair," for-profit representatives make an incorrect assumption that the favorable treatment (tax-exemption) afforded nonprofit organizations results in an unreasonable advantage that is misused to benefit the operators of the nonprofit entity. Allegations that the "costs" which result from the granting of tax exemption are not justified by the "benefits" to society are not supported when subjected to rigorous, objective analysis. Largely, the advantages alleged by critics are either overstated, misunderstood, or matched by other advantages available to the for-profit sector, while at the same time, the economic value of the public good achieved is either underestimated or ignored.

Representatives of the for-profit sector have focused considerable attention on the need for a "level playing field" on which the nonprofit and for-profit sectors operate. Allegations that the playing field is tilted in favor of nonprofit organizations due to the tax and other advantages afforded tax-exempt organizations, are, we assert, fundamentally flawed when applied to nonprofit vocational rehabilitation facilities such as Goodwill Industries.

In fact, our analysis indicates that it is Goodwill which operates at a disadvantage when compared to for-profit businesses, as evidenced by the following:

- Goodwill supports the tax base. Like for-profit businesses, Goodwills pay employer and various other taxes. In addition, employees of Goodwill, as other employees, pay income and other taxes on their employment earnings. When compared to for-profit entities, Goodwill incurs a host of self-imposed labor inefficiencies as a result of employment practices designed to facilitate the vocational rehabilitation process. For example, Goodwill employs comparatively more people -- clients undergoing training, while receiving wages based on productivity, and rehabilitated disabled people, who are estimated to have productivity rates as low as 40 percent of their fully-trained, nonhandicapped counterparts employed in the for-profit sector. As a result of a workforce composed largely of individuals with disabilities, Goodwill's employees require additional supervisory personnel (estimated to be 50 percent higher than a for-profit entity) with coincident additional labor costs. Goodwills also strive for the highest possible labor turnover rate, which is achieved through placement of clients and employees into competitive, private-sector jobs, or referral to other programs or community facilities better suited to the individual's vocational needs. Therefore, Goodwill maximizes a cost (training) in support of its charitable mission that for-profit businesses seek to minimize.

  These higher labor costs translate into comparatively higher payroll taxes paid by Goodwill and its employees. Goodwill, through employer and employee taxes, paid a proportionately greater share of its industrial and service contracts revenue to taxing authorities than did the representative for-profit businesses included in Goodwill's analysis: 16.0 percent of revenue versus 12.4 percent.

- In order for Goodwill to fulfill its charitable mission, activities such as those included in this study are necessary to provide a work environment that enhances Goodwill's ability to provide realistic job training and work experience. It is critical to note that Goodwill does not pursue industrial and service contracts operations for financial gain. In fact, economic analysis of these contract operations indicates Goodwills lose 18 cents on every dollar of revenue generated. These operations require subsidization from other Goodwill revenue-generating areas, such as our donated goods program, but they are necessary as an integral part of our overall job training programs.

The argument that Goodwills enjoy an "unfair" competitive advantage as a result of the absence of corporate net income taxes simply is not supported by the facts.

IS THE COMPETITION HARMFUL TO THE NATIONAL INTEREST?

Goodwill's conclusion that there is an absence of "unfair" competition between our members and for-profit entities in similar lines of business leads naturally to the question of whether the limited amount of competition that does exists can be justified on the basis of contributions to the "public good." That is, what is unique about Goodwill's operations that supports the rationale that these activities should continue to be afforded tax-exempt status?

It is necessary to answer this question from three separate perspectives in order to gain a complete understanding of the contributions that result from Goodwill's activities.

Benefits to Government

Our quantitative economic analysis indicates that Goodwill's rehabilitation, training, and placement of individuals with disabilities into gainful employment saves a vast sum of money over each person's work life. For just one annual cohort of Goodwill graduates placed into competitive employment (based on 1985 figures of 11,641 individuals placed), the data suggest minimum savings to the government of $2.2 billion via added tax receipts from employment earnings and elimination of public aid payments over a conservatively projected 23-year period of employment.

Similarly, Goodwill's placement successes directly generate contributions to the nation's Gross National Product. We calculate that this same cohort of placed individuals (11,641) produces an addition to the GNP of $98 million annually. Projected over a 23-year work life, the contribution to the GNP balloons to about $2.25 billion.

This analysis demonstrates that Goodwill's vocational rehabilitation efforts produce tremendous direct and indirect savings to the government. There is nothing to suggest that either the for-profit sector or the government would be in a position to replicate the services provided by Goodwill Industries should legislative or regulatory changes preclude continuation of these activities.

Benefits to the For-Profit Business Sector

As mentioned above, Goodwill has for many years enjoyed a mutually beneficial relationship with the for-profit sector in general, and particularly with small businesses.

In selected industries within certain communities where severe labor shortages exist, Goodwill's output of trained, job-qualified applicants provides significant financial relief to small business entities. Food service and hotel/motel businesses are but two examples of industries beset with acute labor shortages. Goodwill is helping to minimize the impact of those shortages by preparation of a ready pool of dependable workers who have acquired, through Goodwill's efforts, specific skills applicable to these business operations.

Another goal of the Goodwill vocational rehabilitation process is to lessen the burden to potential employers of training new employees. Through Goodwill's efforts, for-profit small businesses avoid a portion of new employee orientation and training expenses that would occur in Goodwill's absence.

Finally, Goodwill's industrial and service contracts programs, the very component of our operations most susceptible to allegations of "unfair" competition, directly benefit many small businesses. These contracts, serving primarily local for-profit small business customers, provide high quality services at competitive prices. If Goodwill were prevented from offering these services, for-profit businesses contracting with Goodwill would be forced to seek services from more costly and less convenient sources.

Benefits to Individuals with Disabilities Served by Goodwill Industries

Benefits to government and to for-profit entities are easily expressed through objective economic analysis. More subjectively, but equally important we assert, are the benefits provided to individuals with disabilities as a direct result of Goodwill's programs. We believe that encouraging greater economic and social independence of individuals with disabilities and other barriers to employment clearly is recognized to be in the national interest. Federal, state, and local governments support various social programs that encourage and support the transition of individuals with disabilities from "tax-consuming" citizens to taxpayers. Utilization of the Internal Revenue Code to support these important social objectives is an integral component of the nation's human services delivery system which must not be substantially altered if human service organizations such as Goodwill Industries are expected to continue to provide needed services.

RECOMMENDATIONS

Goodwill Industries' conclusions and recommendations to the Subcommittee on Oversight follow:

- We assert that not only are allegations of "unfair competition" overstated, but objective, quantitative analysis demonstrates that any economic advantages available to Goodwill Industries through its tax exemption are offset by the provision of human services which significantly contribute to the general good of society.

- We agree with Treasury's assessment that "efforts should focus instead on obtaining more detailed information concerning the revenues of exempt organizations and the basis for treating them as tax exempt." A radical move away from the substantially related test would seriously undermine Goodwill's ability to provide vocational rehabilitation services to people with disabilities and other barriers to employment so that they may become taxpayers rather than tax users.

- We further support Treasury's proposal to require more detailed reporting of income-producing activities as a means of improving compliance and enforcement.

- We strongly agree with Treasury's assessment that taxing the income generated through the sale of donated property "would generate little, if any, taxable income, and that the exception is justified on grounds of administrative convenience." Elimination of this exemption would greatly restrict our ability to offer rehabilitation services and might well cause many Goodwill ymembers to cease operations.

- There is one issue related to the donated goods exemption which we believe merits examination by the Oversight Subcommittee -- situations where a nonprofit organization has "contracted out" the collection and sale of donated goods (which are tax deductible for those individuals who itemize their returns) to a for-profit firm for which the nonprofit organization is paid a royalty for the use of its name. We believe these types of arrangements violate the intent of the donated goods exemption.

- An examination of Goodwill operations will support the conclusion that we conduct a variety of lines of business which are also conducted by for-profit entities. Such a cursory examination, however, does not reveal the degree to which similar lines of business are conducted in the same market area. The fact that Goodwill may provide custodial services in San Diego does not constitute competition to a for-profit business in Kansas City. Each Goodwill facility provides vocational services to meet a clearly identified community need that in all likelihood would not be met by either federal, state, or local governments, or the for-profit sector in Goodwill's absence.

- Allegations that the "costs" which result from the granting of tax exemption are not justified by the "benefits" to society are not supported when subjected to rigorous, objective analysis. Largely, the advantages alleged by critics are either overstated, misunderstood, or matched by other advantages available to the for-profit sector, while at the same time, the economic value of the public good achieved is either underestimated or ignored.

- Our analysis indicates that it is Goodwill who operates at a disadvantage when compared to for-profit businesses. Goodwill incurs a host of self-imposed labor inefficiencies as a result of employment practices designed to facilitate the vocational rehabilitation process. These higher labor costs translate into comparatively higher payroll taxes paid by Goodwill and its employees.

- In order for Goodwill to fulfill its charitable mission, industrial and service contract activities are necessary to provide a work environment that enhances Goodwill's ability to provide realistic job training and work experience. It is critical to note that Goodwill does not pursue industrial and service contracts operations for financial gain. In fact, economic analysis of these contract operations indicates Goodwills lose 18 cents on every dollar of revenue generated.

- Our quantitative economic analysis indicates that Goodwill's rehabilitation, training, and placement of individuals with disabilities into gainful employment saves a vast sum of money over each person's work life. Similarly, Goodwill's placement successes directly generate contributions to the nation's Gross National Product. This analysis demonstrates that Goodwill's vocational rehabilitation efforts produce tremendous direct and indirect savings to the government.

- Goodwill has for many years enjoyed a mutually beneficial relationship with the for-profit sector in general, and particularly with small businesses. In selected industries within certain communities where severe labor shortages exist, Goodwill's output of trained, job-qualified applicants provides significant financial relief to small business entities. Goodwill is helping to minimize the impact of those shortages by preparation of a ready pool of dependable workers who have acquired, through Goodwill's efforts, specific skills applicable to these business operations. For-profit small businesses avoid a portion of new employee orientation and training expenses that would occur in Goodwill's absence.

- More subjectively, but equally important we assert, are the benefits provided to individuals with disabilities as a direct result of Goodwill's programs. We believe that encouraging greater economic and social independence of individuals with disabilities and other barriers to employment clearly is recognized to be in the national interest.

Est. 1957

haviland hearing aids

1336 E. WISCONSIN AVENUE
APPLETON, WISCONSIN 54911
(414) 733-7525

June 30, 1987

Robert J. Leonard
Chief Counsel, Committee on Ways & Means
U.S. House of Representatives
Longworth House Office Bldg   Rm 1102
Washington, D.C. 20515

Dear Mr. Leonard:

My question is not a new one, but it must be answered if our private-enterprise economy is to survive and prosper:

The question is: "If tax-free, non-profit institutions are allowed to unfairly compete with private enterprise, and if such actions ultimately force the tax-paying businessman out of business, who then will pay the taxes necessary to support our government and it's programs?"

My concern is not only with the tax-exempt universities and hospitals who dispense hearing aids, but applies to all the other business sectors who operate at a severe competitive disadvantage--one created by the tax codes of our own government.

I thank the members of the Ways and Means Committee for looking into this situation and look forward to the legislative remedy that will correct it.

COMMITTEE ON
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WAYS AND MEANS

Yours truly,

HAVILAND HEARING AIDS

Richard H Haviland

Richard H Haviland

cc: James Lovell,
National Hearing Aid Society

Doug Johnson,
Wisconsin Alliance of Heariang Professionals

HEARING AID ASSOCIATES
PROFESSIONAL VILLAGE
119 DAVIS ROAD
MARTINEZ, GEORGIA 30907
PHONE (404) 868-8862

COMMITTEE ON
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JUL 2
WAYS AND MEANS

July 16, 1987

Mr. Robert J. Leonard, Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
Longworth House Office Building
Room 1102
Washington, D.C. 20515

Dear Mr. Leonard:

We would like to express our views on commercial activities conducted by tax-exempt and tax supported organizations. We feel they are blatently unfair.

By their own admission, they say they are out to create revenues that will make a contribution to overhead or excess receipts over disbursements. They say that they need this revenue to keep their doors open. No kidding! What do they think a private business creates revenues for?

We have had clients come to us for testing, evaluation, and a recommendation. They then take that recommendation to the non-profit organization which has the ability to undercut our price. We don't mind competition as long as the ground rules are the same for all the players. When we go up against a non-profit organization, we have got at least one strike against us.

From 1975 to 1983, the nation's tax-exempt income grew 273% to $314 billion. It is now probably well over 10% of the GNP and growing like Topsy. These activities make it even more difficult to achieve a balanced budget.

The unfair competitive impact of the sales activities of non-profit organizations on small tax paying firms is a serious situation that deserves serious consideration by policymakers.

Sincerely,

William J. & Dolores P. Kemple

William J. and Dolores P. Kemple
Proprietors

cc: N.H.A.S.
    G.H.A.S.
    Hon. Sam Nunn
    Hon. Wyche Fowler
    Hon. Doug Bernard

People You Can Trust With A Personal Touch

DOROTHY COUNCILMAN
Certified Hearing Aid Audiologist
Certified by National Board in Hearing Aid Sciences

DELORES SUTHERLAND - R. N.
Associate - Ohio Hearing Aid Society

HEARING AID CENTER
Telephone 229-9736
305-307 Suite Metropolitan Bank Bldg.
LIMA, OHIO 45801

June 22, 1987

Gentlemen:

By way of introducing myself, I am Dorothy Councilman, a pioneer in the Hearing Aid Profession, having served the hard of hearing for 41 years.

You are certainly aware of the unfair and unethical competition we, the private hearing aid dispensers, are receiving from hospitals, clinics, etc. all of whom claim to operate as non-profit entities.

I have worked long hours, days, nights and week-ends, to build my business without any donations or subsidies. And I alone have been responsible for paying my taxes. Isn't it ironic that non-profit organizations with all the tax benefits they receive are forcing us out of business? These institutions are out to make money, have no doubt on that. I couldn't afford to spend in a year the amount of money they spend in a month in radio, TV, newspaper advertising and free publicity. These ads are strictly commercial, the same as the Hearing Aid dealers.

I was recently hospitalized and felt I was being robbed. Here I was paying the hospital who was using my tax money to compete with me and other Dealers. In our city, it is definitely a case of complete hearing aid fittings by the two hospital in direct competition with us at prices slightly less than the average Hearing Aid Dealer.

I request that you consider this matter of unfair competition between tax-paying businesses and private non-profit organizations, and give whatever help you can to remedy this unfair situation.

Very truly yours,
Dorothy Councilman
DOROTHY COUNCILMAN
HEARING AID CENTER

DC/jk

Can Your Baby Hear?

Your child's most important learning will take place between birth and age four. So it's essential that your baby has usable hearing.

You can do some simple tests to find out if your baby has normal hearing. Check to see if the baby can do most of the things listed. If he can't, don't wait. He may have a hearing problem. Tell your doctor immediately.

If your doctor cannot accurately test your child, contact The Hearing Professionals at Lima Memorial Hospital. It is vital that your child receive proper medical help and whatever special training is needed, as early as possible.

Hearing Checklist

Birth to 3 months — Is startled by loud sounds; is soothed by mother's voice.

3 to 6 months — Turns eyes and head to search for location of sound; respond to mother's voice; imitates his own noises; enjoys rattles and other sound-making toys.

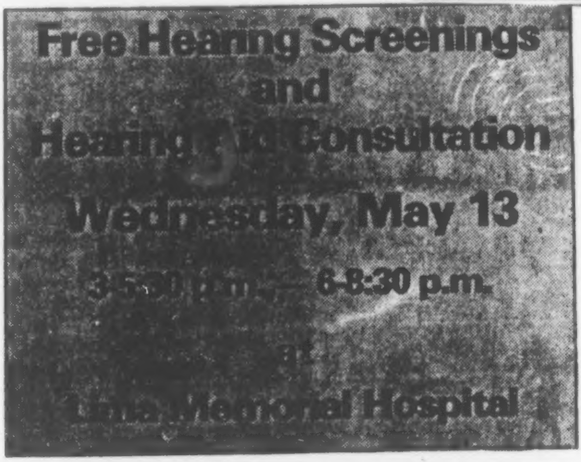
6 to 10 months — Responds to his own name, telephone ringing and someone's voice, even when not loud; understands "no", "bye-bye" and other common words.

10 to 15 months — Can point to or look at familiar objects or people when asked to do so; imitates simple words and sounds.

15 to 18 months — Follows simple spoken directions; first words are spoken; many more words spoken by 18 months.

Contact:
The Hearing Professionals
at
Lima Memorial Hospital
Speech & Hearing Clinic
1001 Bellefontaine Ave.
Lima, OH 45804
Ph. (419) 226-5070
Hours: Monday, Tuesday,
Thursday, Friday:
9 to 5
Wednesday: 8:30-8:30

Tuesday, May 5, 1987



Free Hearing Screenings
and
Hearing Aid Consultation

Wednesday, May 13

3-5:30 p.m. — 6-8:30 p.m.

at

Lima Memorial Hospital

The Hearing Professionals at Lima Memorial will hold an open house in the hospital's Speech & Hearing Clinic. Free, simple hearing screenings and consultation regarding hearing aids and other assistive listening devices will be offered. Information and demonstrations for all types of assistive listening devices will be offered. Reservations are not necessary.

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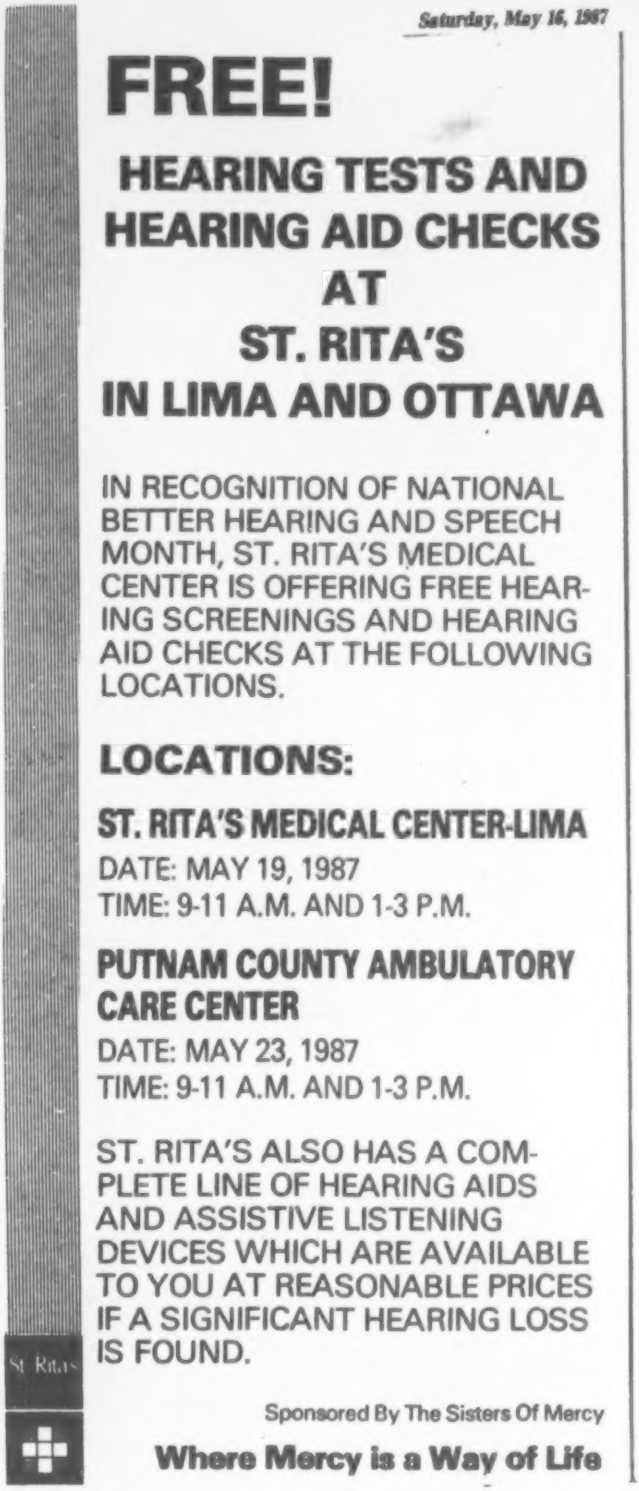

Saturday, May 16, 1987

FREE!

HEARING TESTS AND HEARING AID CHECKS AT ST. RITA'S IN LIMA AND OTTAWA

IN RECOGNITION OF NATIONAL BETTER HEARING AND SPEECH MONTH, ST. RITA'S MEDICAL CENTER IS OFFERING FREE HEARING SCREENINGS AND HEARING AID CHECKS AT THE FOLLOWING LOCATIONS.

LOCATIONS:

ST. RITA'S MEDICAL CENTER-LIMA

DATE: MAY 19, 1987
TIME: 9-11 A.M. AND 1-3 P.M.

PUTNAM COUNTY AMBULATORY CARE CENTER

DATE: MAY 23, 1987
TIME: 9-11 A.M. AND 1-3 P.M.

ST. RITA'S ALSO HAS A COMPLETE LINE OF HEARING AIDS AND ASSISTIVE LISTENING DEVICES WHICH ARE AVAILABLE TO YOU AT REASONABLE PRICES IF A SIGNIFICANT HEARING LOSS IS FOUND.

St Ritas

Sponsored By The Sisters Of Mercy

Where Mercy is a Way of Life

Hearing Aid Specialists

June 8, 1987

Mr. Robt. J. Leonard, Chief Counsel
Committee on Ways & Means
U.S. House of Representatives
Longworth House Off. Bldg., Rm. 1102
Washington, DC 20515

Dear Mr. Leonard:

Since three or four non-profit organizations have started dispensing hearing aids in our area, our sales have dropped from a high of 643 in 1983, 604 in 1984, 574 in 1985, and 473 in 1986. At this rate it will not be very long before we are out of business. We do not mind competing with competitors on the same level but it is impossible to compete with non-profit organizations and all their benefits. If you would like, I would be happy to name these organizations.

Also, all the doctors have taken to dispensing aids and hiring audiologists on their staff. The unfair part is they will charge $120 or more for the test, bill third party companies which only pay doctors, because they refer to their own audiologists who have opened an office down the hall under a different corp., backed by the doctor. They sell the aid for $350 because the M.D. has already been paid his fee.

The small hearing aid dealer is cut out by the birth-to-death approach by the medical profession. Of course the patient is not going to second-guess the M.D.

I personally think the non-profit organizations and the doctor's birth-to-death approach give both groups an unfair advantage. As I said before, we are willing to compete on product, skill, and expertise but it seems the special interest groups have won unfair advantage again.

Sincerely,

Cary W. Greene

Silver Spring
10401 Georgia Avenue
Silver Spring, MD 20902
(301) 649-5555

Prince Georges
4302 St. Barnabas Road
Marlow Heights, MD 20748
(301) 423-2630

Annapolis
2083 West Street, Rm 2c
Annapolis, MD 21401
(301) 224-4343

Gaithersburg
9711 Medical Center Drive
Suite 212
Rockville, MD 20850
(301) 251-1400

TUESDAY,
April 14, 1987

If he wears a hearing aid...

1. Don't shout. The hearing aid is already amplifying your voice. A loud voice actually can make understanding more difficult.

2. Speak naturally. Do not rush or slur your words.

3. Make sure the hearing-impaired listener can see your face. Your eyes, expressions and gestures are important in communicating.

4. Be sure you have the person's attention before you try to communicate.

5. Don't cover your mouth, talk with your mouth full, or smoke while speaking.

6. Background noise (TV, stereo, crowd) makes it very difficult for a hearing-impaired listener to understand, even when wearing a hearing aid.

7. If you find that you have not been understood, it's wise to rephrase your comment rather than parrot the same words over and over again. Different words or phrases may be more easily understood.

8. If the person wears a hearing aid, don't devise unusual tests (i.e. speaking from a different room) to prove the effectiveness of the hearing aid(s). A hearing aid does not cure a hearing loss, it amplifies sound to make it easier to hear.

Contact:
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Speech & Hearing Clinic
1001 Bellefontaine Ave.
Lima, OH 45804
Ph: (419) 226-5070
Hours: Monday, Tuesday,
Thursday, Friday:
9 to 5
Wednesday: 8:30-8:30

STATEMENT OF THE
HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION
to the
HOUSE WAYS AND MEANS/SUBCOMMITTEE ON OVERSIGHT
on
THE UNRELATED BUSINESS INCOME TAX

July 17, 1987

SUMMARY

- Current Internal Revenue Service (IRS) guidelines are adequate in defining unrelated business activities.
- Allegations of unfair competition are incorrectly portrayed as a conflict between tax-exempt organizations and investor-owned enterprises. The conflict is more appropriately identified as big organization vs. small organization.
- Organizations professionally managed as "business-like" organizations should not be confused with commercial entities that have a profit motive resulting in private inurement.
- A great effort has been made by the healthcare industry to ensure compliance of 990T filing requirements.

About HFMA

The Healthcare Financial Management Association (HFMA) is a professional membership association composed of over 26,000 individuals in 75 chapters who share an interest in financial management of hospitals and other healthcare institutions. These are the individuals with primary responsibility for the fiscal health of hospitals and other institutional healthcare providers across the country.

Because most of HFMA's members work in tax-exempt healthcare organizations, HFMA has a keen interest in the unrelated business income tax (UBIT).

In late 1986, HFMA undertook a joint effort with Arthur Andersen & Co. that resulted in "A Preparation Guide for Tax-exempt Organizations and Other Healthcare Organizations" to use for completion of IRS forms 990 and 990T. Information in this guide has significantly aided self-compliance by the healthcare industry with current UBIT requirements.

Current UBIT Guidelines Are Adequate

HFMA believes that current IRS guidelines are adequate to identify unrelated business activities. Our nation's healthcare delivery system is diverse, with each healthcare organization having a uniqueness that stems from its origin and mission within its community.

Current guidelines recognize this uniqueness because they provide flexibility and methods for evaluating the appropriateness of exemptions based on individual facts and circumstances. The current broad guidelines foster a large number of private letter rulings. While some would conclude this is due to vagueness in the law that should be revised, HFMA takes the view that the volume of rulings exists because entities are taking great care to assure that their unique circumstances are understood and evaluated. Rulings are a quest for certainty, not an answer to ambiguity. HFMA also notes that the volume and speed of the service's responses indicate that they are not overwhelmed by the current system and are administering it well without undue burden.

Unfair Competition

The charge of "unfair competitive advantage" has been leveled against tax-exempt organizations by investor-owned enterprises for many years. Each time this charge focuses on the supposed competitive advantages that tax-exempt status gives a nonprofit organization over a small for-profit business. This portrayal is misleading -- the true conflict is that of a big corporation versus a small corporation. When arguments for UBIT are considered in this more accurate light, it becomes more difficult to decide who may have or want to gain a competitive advantage. To illustrate:

> A hospital may have a clinical laboratory as a part of its organization that developed over time in response to physician staff demand. The hospital may have purchased equipment for its exempt purpose. The hospital laboratory performs tests for both inpatients and for patients seen in outside physician offices. The hospital pays UBIT on the outside activity.
>
> An investor-owned laboratory also exists and competes in the same service area. The owner purchased equipment, incurred other expenses, and pays taxes on profits. The owner may have been granted a government small business loan and is paying income taxes on his profit under Subchapter S corporation guidelines.

Several competitive factors are probably involved in the example, such as quality and timeliness of results, convenience, and pre-existing physician referral patterns. These competitive forces may serve to reduce cost and create better service which clearly benefits the community. In competitive healthcare markets, price is not the primary reason for gaining market share. Because price is set by both tax-exempt and investor-owned enterprises in relation to cost, the additional cost component related to status does not have a major role in competition. Therefore, we argue that "unfair competition" is not a function of tax status, particularly in healthcare activities.

Gift shops and cafeterias also illustrate the true nature of the conflict, demonstrating that price and tax status are not a factor. A hospital gift shop could sell merchandise at a lower price because of volunteer help. However, because they are primarily run as fundraising activities, prices are usually not lower than at private enterprise shops. Most people patronize hospital gift shops because of the convenient location to a sick patient they are visiting. The same thing is true with hospital cafeterias that are open to the public. Rarely would an individual seek out a meal in such a facility if they were not visiting a patient. Unrelated business income tax is paid in both circumstances, although the tax does not truly address an unfair advantage a hospital may have competing with an investor-owned business.

It is important to recognize that size is a major contributor to the tension that exists in a competitive market. A hospital with a larger administrative staff and resources may be perceived as having an advantage over a smaller staffed investor-owned enterprise. But, the same entity would also face the same challenges if a larger investor-owned entity tried to enter the same market area. Those who complain of unfair competition may really be seeking an absence of competition.

"Business-like" Organizations

Throughout America's tax-exempt organization board rooms, trustees regularly evaluate whether their organizations are fulfilling their mission most effectively and efficiently. This emphasis on efficiency is gaining momentum as traditional government funding for healthcare and other charitable services is shrinking. As organizations give greater attention to efficiency, the absence of private inurement in nonprofit organizations is a more significant consideration. Because managers in the tax-exempt sector are appropriately adopting "business-like" practices to enhance productivity and retain quality, their organizations are being mislabeled as businesses in the commercial sense. It is very important to recognize that surpluses or "profits" benefit the community and are not going to individuals. Private inurement is strictly forbidden and various innovative methods of encouraging productivity (i.e., certain salary incentive plans) must be rejected. Most state laws also specify that all assets of a nonprofit organization belong to the community. These laws direct distribution of assets of a terminating tax-exempt entity only to other tax-exempt entities in the community, further reinforcing that a community and not individuals benefit from the tax-exempt organization.

It is also important to note that trustees of tax-exempt entities are business people themselves and have a fiduciary responsibility for these entities. These trustees work very hard to discern what is in the best interest of their communities. National solutions are not needed because local community leaders are better able to deal with these local issues, including fair competition, than are national rules.

Healthcare Industry Compliance

The healthcare industry has given considerable attention to ensuring compliance with existing UBIT provisions. These efforts include publication of guidebooks, extensive educational training, and efforts to draw attention to UBIT and its filing requirements. This effort is appropriate because contributions have not kept pace with rising cost of fulfilling community needs and because government payments and support are being curtailed. As a result, alternative sources of revenue are essential. This new emphasis on new forms of revenue makes compliance with UBIT requirements more critical and the industry has demonstrated its intention to comply. Harsh measures in the name of changing UBIT which undermines the organizations' financial ability to fulfill its mission are inappropriate.

Conclusion

HFMA urges Congress to maintain the current UBIT provisions. HFMA welcomes the opportunity to participate in such evaluations and appreciates this opportunity to make our views known.

RRK/mlh/mp

STATEMENT OF HOSPITAL TRUSTEES OF NEW YORK STATE
SUBMITTED TO
SUBCOMMITTEE ON OVERSIGHT
OF THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
HEARINGS ON UNRELATED BUSINESS INCOME TAX
JUNE, 1987

On behalf of the 4,000 trustees of voluntary hospitals who are members of Hospital Trustees of New York State, Hospital Trustees of New York State is pleased to submit the following comments for the record on the Unrelated Business Income Tax Hearing.

The Voluntary Not-for-Profit Sector -- Its Distinction

The questions raised by the Subcommittee for purposes of this hearing pertain to the voluntary sector as a whole. In fact, many of the issues raised remind us that behind the specific areas of concern regarding "unfair competition" stands the fundamental question of how our society is structured for the delivery of services to its citizens. We have lived with these issues since the inception of our hospitals, and have focused on them in detail recently. We were a participant at the Small Business Administration's Roundtables on unfair competition in January of this year. As we have followed this debate over the past few years, beginning late in 1983 with the publication of a report entitled, "Unfair Competition by Nonprofit Organizations with Small Business: an Issue for the 1980s," we are reminded that several factors have led to these hearings:

- An era in which there have been successful attempts to minimize the dependence upon federal funds for many social programs, and,
- Encouragement of a "private sector" response for social programs.

The result has been a society in which the delivery of services by voluntary organizations and government has changed. We now find that there are those who question the validity of the voluntary sector -- and we seem to have forgotten that ours is a pluralistic society in which the three sectors have existed side by side in service to the needs of our citizens.

We wish to reiterate that we continue to support such a pluralistic approach to services, and we believe that the original rationale for the exemption from taxes for the not-for-profit sectors remains valid:

> "the exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds and by the benefits resulting from the promotion of the general welfare." H.R. Report No. 1860, 75th Congress, 3d Session (1938).

While the focus of these hearings is the unrelated business income of voluntary not-for-profit organizations, Hospital Trustees believes that it is important to examime the basic tenents that are the foundation for the tax-exempt status. In return for tax-exempt status, not-for-profit organizations must:

- Deliver a public good which is charitable in nature;
- Remain accountable to the public through a variety of means (volunteer governing boards, tax returns and annual statements which are available to the public);
- Serve a significant segment of the community;
- Direct the operating funds and surplus towards the charitable purpose for which the organization was created. In the event of the dissolution, the assets must be distributed to serve public purposes; and,
- Adhere to the provisions of the tax code and its regulations when undertaking activities which are either related or unrelated to the organization's exempt purpose.

Unrelated Business Income

With regard to the voluntary not-for-profit hospitals in New York State, Hospital Trustees of New York State puts forward the following comments in response to the issues outlined and discussed by the committee to date:

1. To evaluate activities which may be unrelated to a hospital's mission, such activities must be examined on a case by case basis. Where necessary, Hospital Trustees would support improvements in information collection and reporting.

2. We have no evidence to date which suggests that voluntary hospitals are ignoring the law with respect to activities which are unrelated to their exempt purpose. In fact our hospitals, under the direction of their boards, do not undertake new ventures without legal advice regarding the structure of such activities.

3. The fact that hospitals have diversified both their services and activities into areas in which small business operates is not in and of itself bad. In fact, the underlying reasons and social policy implications of such diversification will, we believe, lead many to affirm the necessity and continuation of such activities. Those underlying reasons and benefits include:

    - the recognition that health care for those who are sick is deemed a right not just a privilege by society, and therefore we must find ways to subsidize services for those who cannot pay for hospital care;

- the delivery of services for which there is little or insufficient reimbursement (e.g.. burn units must be continued);
- the belief that the continuum of care should be operative in the delivery of health care services by hosptials, and that services to patients may extend beyond the traditional inpatient setting; and,
- understanding that society desires that health care costs be contained at the same time that progress in health care is ensured, whether that be through the endeavors of research, the invention of new medical technologies, or the training of our future physicians and nurses.

Such powerful considerations create the landscape on which today's hospitals exist. They also continue to meet the original goal set forth by the enabling legislation -- their services relieve the government from expenditures they would have to make, and they promote the general welfare. Our challenge is to meet these needs in a way which will further the needs of society and preserve a strong heath care system for future citizens.

The voluntary hospitals in New York State exemplify the concerns we have articulated here. New York hospitals exist within the confines of charge control and cost containment legislation. New York hospitals cannot turn people away from their emergency rooms regardless of ability to pay. New York hospitals pool their dollars to form a bad debt and charity care fund which reimbursed hospitals in 1986 for $442 million of the $741 million in bad debt and charity care need. New York is one of the only states which does not allow publicly traded corporations to own and operate hospitals within its borders.

Hospital Trustees of New York State hopes that future discussions of the issue will consider our underlying assumptions and expectations of our health care system in general, and our voluntary hospitals in particular. We also urge that the strengths and contributions of the voluntary not-for-profit sector be factored into future deliberations. Hospital Trustees wishes to thank the Subcommittee for the opportunity to voice its concerns, and looks forward to working with the Subcommittee in the future.

TROUTMAN, SANDERS, LOCKERMAN & ASHMORE
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STANLEY H. HACKETT, P.C.

WRITER'S DIRECT DIAL NUMBER
658-8364

JUN 29 1987

June 18, 1987

RECEIVED
JUN 23 1987
Ways and Means
Subcommittee on Oversight

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways & Means
U. S. House of Representatives
Washington, D.C. 20515

Re: Hearings on unrelated business income tax - June 22, 1987

Dear Mr. Chairman:

In connection with the Oversight Subcommittee's review of the unrelated business income tax, we would appreciate your consideration of the comments which follow. These comments are submitted on behalf of our client, Jebco, Inc., of Warrenton, Georgia. We would appreciate your incorporating this letter in the official record of the hearings which will begin on June 22.

Jebco is a contract manufacturer of metal office furniture principally for sale to the General Services Administration and the United States Postal Service. It is located in Warren County, Georgia. Over 65% of its employees are minorities. It has some employees who are physically handicapped and other employees who are over the age of 65. It is a small business under any definition of the term.

For over thirty years, Jebco has competed for and won contracts to provide a variety of items of metal office furniture (e.g., bookshelves, tables, etc.) to various government agencies. In recent years, Jebco has been aware that solicitations to bid on a number of these items were no longer being sought by the government, but was under the impression that these items simply were no longer being acquired. Over the last two years, however, Jebco has learned that these items are being acquired, but pursuant to various government programs, are being acquired solely from certain tax exempt manufacturing facilities. The cumulative impact on Jebco of these various programs has been considerable. Jebco's current employment is approximately one-half of what it was just a few years ago. Scores of items that Jebco used to compete for have been removed from competition. Like its small business competitors, Jebco now finds itself bidding for fewer and fewer items, and is concerned that no one in government is monitoring or indeed even aware of the cumulative impact of these programs. If the impact of these programs were spread out among all taxpaying businesses, or even among all taxpaying businesses which deal with the government, the impact might be minimal. However, the impact is not spread out. It typically is focused on small businesses, and particularly those like Jebco, which provide entry level industrial employment and are fairly labor intensive.

At the present time, there are two major government programs under which tax exempt entities are awarded, without competition, permanent and exclusive contracts to supply to the federal government items which previously were the subject of competition by taxpaying businesses. Under the Javits-Wagner-O'Day Program and the Federal Prison Industries Program, literally hundreds of millions of dollars of products and services that used to be the subject of competition have already been awarded to tax exempt entities. In fiscal 1986, the Javits-Wagner-O'Day Program involved approximately $300 million in goods and services. In fiscal 1985, the Federal Prison Industries Program involved approximately $70 million in furniture and furniture accessories alone. These two programs are growing everyday. Furthermore, in recent years, legislation has been introduced which would allow many of these same entities the additional opportunity to compete for government contracts which previously were set aside specifically for competition by taxpaying small businesses. While the legislation was defeated last year, efforts to gain its enactment undoubtedly will continue. Each of these programs may have merit, but no one seems aware of the tremendous cumulative adverse impact these programs have had and continue to have on taxpaying businesses.

Jebco and other businesses pay federal, state and local taxes. They must comply with a multitude of employment and labor laws including minimum wage laws. They pay Social Security taxes. The tax exempt facilities, on the other hand, raise capital through tax deductible charitable contributions and various government grants or other government funding. Although often quite profitable, they pay no taxes. In many cases their employees are not considered regular employees and are paid subminimum wages with no Social Security or fringe benefits. How can small taxpaying businesses conceivably compete with these entities?

Tax sheltered manufacturing facilities awarded contracts under the Javits-Wagner-O'Day Program pay no income taxes since the income derived from their business arguably is related to their stated exempt purpose. The stated exempt purpose typically is to provide rehabilitative and therapeudic employment to individuals who are under disabilities which are so severe as to prevent the individuals from currently engaging in normal competitive employment. If employment in the facilities were in fact so limited, there might be no particular issue of federal taxation. Rather the issue would be one of competing social policies and allocating scarce government resources.

However, Jebco is concerned that in too many cases, the facilities operate beyond their intended purpose. In hearings before the House Small Business Committee last year, testimony was presented which reflected that in many cases, "sheltered workshops" are not providing rehabilitation and therapeudic treatment, but rather the workers are often providing ordinary employment at substandard wages and under substandard working conditions. In other words, although disabled, the employees are capable of normal employment and are providing normal employment. The facilities are not "workshops" in the sense of small, handcraft oriented operations, but large, well-capitalized industrial manufacturing plants.

Jebco, like all good citizens, supports a policy of helping those less fortunate. Training and rehabilitation of the disabled is not only worthy of support, but makes good common sense. When the point comes, however, that individuals, although disabled, are capable of regular employment and are working in facilities which are functionally the same as their private sector counterparts, questions must be raised as to the amount and degree of taxpayer subsidy that is appropriate. When favortism through administrative award of contracts is coupled with tax exempt status, the ability to raise capital with tax deductible contributions and government grants, and exemption from minimum wage, labor and Social Security laws, an awesome competitor to small, taxpaying businesses is created. While the broader social policy issues regarding these programs may not be within the jurisdiction of the Ways and Means Committee, the taxation of the facilities clearly is.

The current definition of "unrelated trade or business income" is loose. It is subject to interpretation and manipulation which is difficult to monitor. In some cases, the very purpose of the tax exempt entity appears to be to engage in a trade or business. We question whether audits will ever be sufficient to detect and curb abuses. Accordingly, we suggest that "trade or business" income of all entities, whether taxable or tax exempt, and whether the income is "related" or not, be subject to income tax.

We appreciate the Committee's consideration of these comments.

Very truly yours,

Troutman, Sanders, Lockerman & Ashmore

By: ______________________________
Stanley H. Hackett
Attorneys for Jebco, Inc.

June 11, 1987

FROM: Kalman R. Katz BC-H.I.S.
965 N. Alvernon Way
Tucson, Arizona 85711
(602)-326-3131

TO: Representative J.J. Pickle, Chairman
Subcommittee on Oversight
House Ways and Means Committee

STATEMENT: IMPROPER COMPETITIVE ACTIVITIES OF NOT FOR PROFIT ORGANIZATIONS

In our society the survival of a small businessman is never assured. But, if he works hard, provides good service at competitive prices, and responds to consumer demands he should be able to make a living and prosper. In this endeavor he must also be able to respond to activities of his competition, but as long as the "Playing Field" is level his survival is in his own hands.

The problem as I see it, is that this "Playing Field" we small business people play on is no longer level. The entry into the free-market of "Not For Profit" businesses and organizations has created some tremendous distortions in our economy. What may at first have been the well intentioned, public service activities of a few organizations who were trying to fill a need, has blossomed into economic activities exempt from the normal economic laws of our society.

Since my profession is the sale of hearing aids and hearing health related services, this is of greatest concern to me. Relative to the activities of the "Not For Profit" sector, I feel I have a very legitimate concern. In my field we now have United Way activities openly advertising for the public to come in and purchase hearing aids. We have "Not For Profit" hospitals selling these essentially prostethic devices. We have state universities selling hearing aids. As these organizations perceive a need for funds, they are increasingly encroaching into activities where they have a distinct economic advantage. They pay no taxes and can solicit even more money from the public as tax deductible contributions. I wish my government would give me such an opportunity.

Here I am an honest taxpayer supporting, through tax exemptions, non-profit non-taxable contributions and government grants the slow annihilation of my own business. Please, I implore you, make the "Playing Field" level again. I do not ask for an advantage, just an equal opportunity.

Not only do I have to contend with all of the above, but due to the public posturing of many of these organizations the public is led to believe they have an expertise, that in fact may not be true. These organizations are able to obtain advertising at no cost, which I must pay for and are able to portray an expertise through the "Halo Effect" which may not be there. This is not fair.

In my own state the legislature passed a law creating a "Non-Profit" corporation out of the University of Arizona Hospital. This corporation then leased its ear, nose & throat clinic to its doctors. The clinic now sells hearing aids in direct competition with me, and in a flagrant circumvention of state law which forbade the sale of prostethic devices.

Not to be outdone, the University of Arizona Speech and Hearing Department has also started selling hearing aids, using as its justification "The inconvenience of having the students learn this activity off campus." Attached to this statement is a copy of the oral statement I gave before an independant state board which reviews improper activities of state agencies in the free-enterprise arena. I think it is pertinent. The board found the University was improperly competing in the marketplace and recommended that the legislature enact a law to terminate the universities sale of hearing instruments.

Your help is urgently needed to restore the balance between the "Non-Profits" and the rest of our free-enterprise system. One drastic way would be to deny "Non-Profit status to any organization which provides any service or product which is available through the free-enterprise system within a fifty mile radius. I am sure others will have suggestions which may be more viable than mine, but I urge you not to delay in taking action on this very important problem.

Thank You,

K. Ray Katz BC-H.I.S.

REMARKS BEFORE THE PRIVATE ENTERPRISE BOARD ARIZONA HEARING AID SOCIETY COMPLAINT AGAINST DEPARTMENT OF SPEECH AND HEARING SCIENCES, UNIVERSITY OF ARIZONA

MAY 19, 1987

Mr. Chairman, Ladies and Gentlemen, my name is Ray Katz. I am a private hearing aid dispenser in Tucson, and I am also a Director of the Arizona Hearing Aid Society.

So that you might better understand our complaint I would like to briefly explain what a hearing aid dispenser is and does. Hearing aid dispensers in Arizona are licensed by the Department of Health Services. They include professionals with a wide array of skills and knowledge. Many have entered the profession through on the job training and correspondence courses, and some after graduating from college and passing a licensing examination. In virtually every case, we are talking about small professional offices of one to six employees.

A hearing aid dispenser, as part of his daily professional activities, tests hearing, counsels the hearing impaired and their families, selects the proper instrumentation for his patients, takes ear impressions, trains the hearing impaired in the use of hearing aids, supports his patients through the sometimes difficult early stages of adapting to hearing aid use, services-cleans-and repairs hearing aids, and is a refereral source for the hearing impaired regarding other rehabilitative activities and equipment. Although many hearing aid dispensers are not University trained we are all involved in a field which requires a great deal of caring, patience and understanding of the needs and frustrations of the hearing impaired.

Since I last appeared before you on February 20, there has been a lot of activity regarding our complaint against the University of Arizona. As per the Board of Regents policy regarding complaints of free enterprise competition, we first pursued a remedy to this situation by going through the University. The University of Arizona Standing Committee on Non-Competition with Free-Enterprise held a hearing on March 2, 1987. This was the day its findings were required to be forwarded to the President of the University, not the day for the initial hearing to take place. The recommendation of this committee was actually forwarded to President Koffler on March 16, 1987, fourteen days late. After some more delay the President's decision in favor of the University was forwarded to this Society. This was some eleven days after the Board of Regents deadline for such action to have been completed.

We then requested an appeal hearing before the Board of Regents. After an exchange of position papers an Ad-Hoc Committee of Board of Regents held a hearing on April 23, 1987. The lack of any formal recording of this meeting serves to underscore the Regents attitude towards this entire process. The Board of Regents then voted to affirm President Koffler's decision.

During this process the combination of comments and actions by the University and Board of Regents points out the futility of asking a state agency to modify its actions when it oversees itself. One of the University Standing Committee members, Billy Joe Varney, Vice-President for Administration, said that "He did not know why the hearing had been called, since as an employee of the University and of the Board of Regents, he could not be expected to vote against them." We asked the Board of Regents to remedy the obvious bias of this committee. We asked that the Board be reconstituted with personnel trained by the Better Business Bureau in problem resolution. This request was ignored.

After the Board of Regents hearing, two members of the Board of Regents, Mr. Herman Channen and Mr. Ralph Watkins said to me that they saw no reason to vote against the University, since the University really wasn't taking that much money out of the private sector.

With comments such as this and the comment of the University Legal Council Mr. Thompson, quoted in the Tucson Citizen newspaper, quote, "We're not saying it will have no effect. But if three sales make or break a business, I would call that a shoestring operation." End of Quote. I think it is fair to say that a decision in favor of free enterprise was virtually impossible, and as characterized by the previous statement, we are not talking about "Big" money at this hearing, but we are, talking about a sum which could have a substantial impact on the livelyhood of small business men and women whose only protection from State bureaucracy is this Board.

Now as to the reason we are here today,. . . the Free-Enterprise Law would allow the University to sell hearing aids, if it could meet either one of two criteria:

1.) That this activity provides an enhancement of the University's public service mission.

2.) That this activity will provide a valuable educational experience to the students.

Since it is safe to say that the retail sale of equipment to the general public cannot be a public service enhancement, we come down to - is this a valuable educational experience?

Now this term "Valuable Educational Experience" is quite broad. So broad in fact, that the Board of Regents Ad-Hoc Committee on April 23, agreed that "how to build a mousetrap" would be considered a valuable educational experience for an audiology student, but even with this they declined to more specifically define what this term should mean.

The University contends that to keep up with others in the audiology field, they must provide their students with more practical experience in the University run clinic. We do not feel that keeping up with the Jones' is a good reason to violate the intent of State law. In truth, they now place these students in four outside facilities besides their own clinic, two hospitals and two private clinical audiology offices and in the words of Dr. Hodgson, Director of the Adult Hearing Clinic, "I'm sure we could find enough people in the community to do all of our clinical training."

So, if this is a valuable educational experience the University could provide it through cooperation with free enterprise facilities. But since we have been unable to get the University or the Board of Regents to define this term "Valuable Educational Experience" we would like to provide our interpretation for your consideration.

The American Speech, Language and Hearing Association sets the course content standards for a degree in Audiology. Since this organization provides a detailed listing of required course content, it would be reasonable to assume that all coursework, which should be considered a valuable educational experience for audiology students would be included in these course standard; however, these standards do not mention,...not even once, that a student have knowledge or experience in selling of hearing aids. It simply states that course content should include, and I quote, "Habilitative/Rehabilitative procedures, such as selection and use of appropriate amplification instrumentation for the hearing impaired, both wearable and group."

Additionally, once a student has graduated with a Masters Degree in Audiology, that student must still serve a clinical fellowship year before the student can practice as an ASHA Certified Clinical Audiologist. If a student wishes to pursue a career in hearing aid dispensing, it is only reasonable to assume that the student will choose to serve his clinical fellowship year in a facility where he can learn how to sell these instruments.

Therefore this Society does not feel it is unreasonable to use the standards of the Speech and Hearing Department's professional organization as a criteria for "Valuable Educational Experience." Using this criteria we would ask this Board to find the University of Arizona Department of Speech and Hearing Sciences in violation of the Non-Competition with Free-Enterprise Law.

The University has used other reasons to justify their sale of hearing instruments. To keep on a par with other universities and to keep their program in the leading group of Audiology courses nationwide. Neither one of these reasons meets the test of the Non-Competition Law, and the American Speech, Language and Hearing Association is unaware of any recognized system which could be used to substantiate the University's claim to a nationally ranked program.

Similarly, the University says it cannot place its students in many of the locations which are available because of the lack of qualified personnel. This seems to be at odds with the statement which I quoted from Dr. Hodgson. But, since the sale of hearing aids is not a course requirement for certification, these students could still be placed with competent businessmen and women who do not hold college degrees without endangering the University's accreditation. In fact, I am sure that most of you would agree that the knowledge gained in the real world is at times more important than that gained in school.

The University has stated that it can not allow its students to learn more about their chosen field in locations outside the University since these students would not be properly controlled by the University. To the contrary, we believe this desire for control can more accurately be attributed to the ivory tower concept than to a desire to provide a truly rounded education.

The University has said the sale of hearing aids is the same as the provision of medical services. We do not believe this to be accurate. In fact, we strongly disagree, and so did the Legislature several years ago when it passed the legislation separating the

University and its hospital. That legislation forbade the hospital from selling rehabilitative equipment. The hospital promptly circumvented that restriction by leasing the entire ear, nose and throat clinic to its doctors and now sells hearing aids, since they say that doctors need to know how to do this also. With all of this is it any wonder that we feel the need to ask for your support. We ask you not to allow the University to circumvent the Free Enterprise Law, as its hospital has circumvented the Legislature.

With this complaint, we are talking about the sale of rehabilitation equipment for profit, not the education of graduate students. To say otherwise would be to say that it is alright for the Business School to open an independent accounting business and real estate sales office, for the Law School to open a general public legal office, for the College of Arts to open a graphic arts business. We believe it is time for the people of this State to say enough is enough. This State was not created for the sole purpose of supporting the Universities of this state. We hope you will agree with us, and in doing so make a strong statement for the independence and viability of our free enterprise systems.

Thank You

La Crosse Hearing Aid Center

724 SOUTH 7TH (GROUND FLOOR) • LA CROSSE, WISCONSIN 54601
TELEPHONE (608) 784-4780

Edward J. Bakalars
CONSULTANT

July 3, 1987

THE HONORABLE J. J. PICKLE, CHAIRMAN
HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE
1105 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515-6350

SUBJECT: UNFAIR COMPETITION FROM CLINICS DOING RETAIL BUSINESS

Dear Congressman Pickle,

You may recall that Senator Brian D. Rude, 32nd Senate District, sent you a copy of a letter that I had written to him expressing my concern about unfair competition from two large, local clinics who began selling hearing aids in 1984. The subject of the letter was "competition from non-profits" but whether these clinics operate as for-profit businesses or non profit is not the critical issue. The issues that should be confronted are unethical practices and unfair competition from the medical profession.

A Federal law enacted in 1977 required that a hearing-impaired person be informed that his best interests would be served by seeing a medical doctor. Hearing-aid professionals were able to live with this law until the medical profession began dispensing hearing aids and became lethal competition. Why has the government put small business in such a predicament and allowed the medical profession to go into retail sales? How ethical can it be for the doctor to sell the product he prescribes? When the clinics are actively taking every customer they can, where does the hearing-aid specialist refer a patient requiring medical attention? For the sake of my patient and in good conscience I have to refer them to a doctor, but it is not easy to send them to the competition!

Regardless of their tax-paying status, both clinics have a very cozy relationship with non-profit hospitals and foundations. This relationship gives them built-in competitive advantages, the most damaging being their "good guy" image and their "captive clientele". No amount of advertising can take away their good guy image or draw away from them those 80% of the hearing impaired who seek medical advise before purchasing their first hearing aid.

Another group of potential customers that are forced to go through a medical facility, thus becoming the captive clientele of the clinics, are those getting a hearing aid through an insurance plan including HMOs and HMPs. State government employees are on an HMO and even though my tax dollars are paying their wages, I cannot sell them a hearing aid.

Welfare recipients, too, are required to go through a medical facility when getting a hearing aid. My tax dollars also help to provide hearing aids for this group, but they are steered by the clinics to the clinics. In 1983, I billed the State of Wisconsin for fifty-three hearing aids for welfare recipients that were referred by the clinics. During the year 1986 and to date in 1987, there was not one person on Medical Assistance referred to me other than those whose initial clinic appointment was scheduled through my office, and one welfare recipient from Minnesota who was referred only because it is considered unethical for an audiologist who lives in Minnesota to refer to himself.

All doctors in our area are affiliated with one of these medical facilities, and more rural hospitals are affiliating with them all the time. In essence, the outlying clinics act as referral centers, extending their reach even further. The trend is toward more and more consolidation and coordination between clinics and hospitals which will develop into an alliance of like-minded institutions that will become anti-competitive.

It also appears that in the future only the largest insurance companies will have HMOs that survive leaving virtually no competition. Quality, too, will be affected by HMOs. Several years ago I spoke to the chairman of the board of a large European hearing aid manufacturing company and he was questioning how to reduce the price of hearing aids so that his company would get the contract to supply hearing aids for HMOs. He said prices could be reduced by eliminating the controls on hearing aids. The end result would not only be reduced prices, but reduced quality and versatility. He was appalled that small hearing aid businesses were being treated so unfairly during the Reagan Administration since the President was supposedly pro-business.

Small hearing aid businesses are being eliminated by competition that has government approval stamped all over it. There used to be anti-trust laws designed to maintain and protect competition but for the sake of the health-care market, the government is looking the other way. By allowing them to control the marketplace, the small hearing aid business will soon be a thing of the past with the long-term impact being increased costs and poor quality as monopolies are formed in the healthcare and insurance business.

Please, can you help us?

Sincerely,

LA CROSSE HEARING AID CENTER

Edward J. Bakalars

cc: President Ronald Reagan;
Senator Brian Rude;
Representative John Medinger;
Robert J. Leonard, Chief Counsel
Ways & Means Committee;
Douglas Q. Johnson, Executive
Secretary, Wisconsin Alliance of
Hearing Professionals;
Jim Bohren, National Hearing Aid
Society

STATEMENT OF

REV. JAMES C. CARTER, S.J.

PRESIDENT OF LOYOLA UNIVERSITY

TO THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

-- HEARINGS ON THE UNRELATED BUSINESS INCOME TAX --

JUNE 25, 1987

* * * * *

I.

Introduction

A. Personal Information.

My name is Rev. James C. Carter, S.J. I am the fourteenth President of Loyola University and have served in that capacity since 1974. Prior to 1974, I was Academic Vice President (Provost) of Loyola (1970-1974) and the Director of Education for the New Orleans Province of the Society of Jesus (1968-1970). In addition, I have served on the following educational and civic-oriented organizations: (1) the American Council's Commission on Leadership Development in Higher Education; (2) the Board of the National Association of Independent Colleges and Universities; and (3) the Board of Directors of the Association of Jesuit Colleges and Universities. My academic training is in the field of nuclear physics, and I have taught physics at Loyola University since 1960.

Loyola University, located in New Orleans, Louisiana, received its charter in 1912. Since then, Loyola University has provided excellent educational opportunities for students of many different backgrounds. Today, Loyola University serves over 5,000 students. Loyola University is exempt from Federal income taxation as an organization described in section 501(c)(3) of the Internal Revenue Code. (Except where otherwise indicated, all references in this statement to "sections" are references to sections of the Internal Revenue Code of 1986.)

B. Overview of Testimony.

I appear before the Subcommittee today to raise certain concerns of Loyola University, and other nonprofit colleges and universities, with respect to the Subcommittee's review of the unrelated business income tax. My primary objective in testifying is to place the Subcommittee's review of the unrelated business income tax in the context of the current status of funding for higher education.

As President of the largest Catholic university in the South, I am acutely aware of the recent reductions in funding from the Federal government for higher education. In this context, I realize how vitally important every dollar of support and revenue is to the continued provision of an excellent education to our students. I am also aware that the Federal government is presently under extreme pressure to address the Federal budget deficit, both with decreases in spending and increases in revenue.

The unrelated business income tax was originally enacted to achieve two objectives. First and primarily, the unrelated business income tax was enacted to eliminate "unfair competition" between taxable and tax-exempt organizations. Second, the tax was enacted to increase Federal tax revenues. See S. Rep. No. 2375, 81st Cong., 2d Sess. 28, 29 (1950). I am concerned that the latter purpose of the unrelated business income tax -- to increase Federal tax revenues -- might become the primary starting point for the Subcommittee's review of the unrelated business income tax. It is my firm belief that this result would pose a significant threat to the capacity of colleges and universities to provide an excellent education. If Federal revenue requirements became the primary motivation for review of the unrelated business income tax, I fear that many activities which have traditionally been conducted as integral parts of university operations, such as the operation of student dormitories or college athletics, would become targets for revenue raising. Such a result would severely exacerbate the already difficult funding crisis being experienced by most colleges and universities, including Loyola University.

Therefore, I appear before the Subcommittee to comment on the troubled status of funding for higher education in this country and the need to conduct the Subcommittee's review of the unrelated business income tax with this fundamental problem in mind. It is my hope that the Subcommittee will consider these facts when determining what revisions, if any, are necessary to the unrelated business income tax provisions.

II.

Status of Federal Funding for Higher Education

The reduction in Federal spending for higher education in recent years has threatened the ability of colleges and universities to provide quality educations to their students. This reduction in the Federal government's investment in education is ill-timed. The training provided at colleges and universities is the primary means by which the United States can remain competitive in rapidly changing international markets.

I understand that these arguments have been and are being made before the Congressional spending committees. My purpose in raising them before this Subcommittee is to assure that the critical funding problem of colleges and universities is included as an important factor in the Subcommittee's review of the unrelated business income tax. With this purpose in mind, I present the following facts on the status of Federal funding for higher education.

In general, Federal support for U.S. Department of Education programs has been declining since 1980. While Federal funds for educational programs have increased on an aggregate basis from $14.5 billion in fiscal year ("FY") 1980 to $19.5 billion in FY1987, the increase has not kept pace with inflation. When adjusted for inflation, a comparison of dollars spent on educational programs in FY1980 to dollars spent in FY1987 shows that Federal funds for education programs have decreased by 5.9

percent since FY1980. Congressional Research Service, Impact of Legislative Changes on Major Programs Administered by the Department of Education, Fiscal Years 1980-1987, Pub. No. 86-990 EPW, p.3 (November 20, 1986).

The President's recent budget recommendations for FY1988 would drastically accelerate the rate of declining Federal support for educational programs. According to a recent analysis by the Congressional Research Service, dated May 15, 1987, Federal spending for FY1988 on educational programs would have to be $20.7 billion in order to continue the current level of service without any policy changes. Congressional Research Service Issue Brief, Education Funding Issues for FY1988, Order Code 1887054, (May 15, 1987). That amount would represent a $1.2 billion increase above the $19.5 billion appropriated for FY1987. The President has recommended that the overall funding level of educational programs be reduced to $14.0 billion for FY1988, a reduction of 28 percent below the FY1987 appropriation. As a part of his recommendation, the President has also requested that a total of $2.7 billion be rescinded from the FY1987 appropriation, thereby decreasing the total appropriation for that fiscal year to $16.8 billion.

The Federal educational programs which have the greatest impact on higher education are those relating to student financial aid. Such aid consists of three basic types of programs: (1) campus-based programs which are administered and awarded by colleges and universities to individual students (e.g., college work-study); (2) loans (e.g., Guaranteed Student Loans); and (3) grants (e.g., Pell Grant Program awards made to financially needy students with no repayment required). Federal aid is also available through the State Student Incentive Grant Program to encourage states to operate their own grant programs. Under the President's budget request for FY1988, funding for campus-based programs would be eliminated. Eligibility for the Pell Grant program would be severely restricted, resulting in a loss of eligibility for an estimated 1 million students. In general, Federal subsidies provided for Guaranteed Student Loans would be reduced. Overall, the President's budget request would reduce student aid as a percentage of the Department of Education's total appropriation from 42 percent in FY1987 to 32.1 percent in FY1988. In FY1982, spending on student financial aid programs constituted 45 percent of the Department of Education's total appropriation.

For Loyola University, reductions in student financial aid programs have an especially harsh impact. Of Loyola's total enrollment of 5,210 students, 2,709 (or 52 percent) receive some form of student aid which enables them to attend Loyola University. The importance of such aid in promoting the educational mission of Loyola is further highlighted when one considers that 1,200 of Loyola's total enrollment of 5,200 students (or 23 percent) are minority students.

The importance of student financial aid to Loyola University may also be seen by examining the role that such aid plays in Loyola's budget. In FY1987, Federal student aid programs administered and expended by Loyola equaled $6 million and other aid programs funded by Loyola equaled $5.5 million, for a total student aid budget of $11.5 million. This amount constitutes approximately 30 percent of Loyola's total budget. The importance of student aid to Loyola University's educational mission is further reflected in the fact that while Federal spending on student aid programs was declining over the five-year period since 1982, Loyola University's contributions to student aid increased from $1.9 million to $5.5 million, an increase of 189 percent. Moreover, 31 percent of financial aid recipients are minority students.

These statistics clearly indicate that the President's proposed reductions in Federal spending on educational programs would have a devastating impact on the ability of Loyola University, and very likely on the ability of other colleges and universities, to continue to provide a quality education to students. Indeed, the trend of reduced Federal spending for higher education has impacted colleges and universities in the worst way -- namely, by restricting access to post-secondary school educations. For Loyola University, where 52 percent of the students receive some form of financial aid, the impact of these reductions has been especially harsh.

III.

History and Purpose of the Unrelated Business Income Tax

In light of the current funding crisis in higher education, an expansion of the unrelated business income tax beyond its current scope would result in additional hardships for most colleges and universities. The current scope of the unrelated business income tax has been carefully crafted by Congress and administered by the courts and the Internal Revenue Service. With respect to educational institutions, the unrelated business income tax provisions currently establish an appropriate balance which permits such institutions to carry on, tax-free, activities which are integral parts of their functions, while taxing activities which would undermine the profitability of taxable enterprises.

As the Subcommittee begins its review of the unrelated business income tax, it is worthwhile to focus on the current scope of the unrelated business income tax as crafted by Congress with a view toward highlighting prior Congressional determinations as to which activities conducted by non-profit educational institutions should be legitimate targets of the unrelated business income tax. To extend the unrelated business income tax beyond this current scope to other activities conducted by colleges and universities would result in an unexpected increase in the tax burden of colleges and universities which, because of continuing reductions in Federal support for higher education, cannot be afforded.

Prior to the enactment of the Revenue Act of 1950, educational and other tax-exempt organizations generally could own and operate a broad range of business and investment activities without jeopardizing their tax-exempt status and without liability for Federal income tax on their business profits. Using what came to be known as the "destination of income" test, courts generally held that such business profits were exempt when they were used to advance the organization's tax-exempt purposes. See, e.g., Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924); Roche's Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938).

In the Revenue Act of 1950, Congress enacted the unrelated business income tax to respond to assertions by taxable business enterprises that the business activities of tax-exempt organizations were causing taxable businesses substantial economic harm. Specifically, taxable businesses claimed that tax-exempt organizations could, by reason of the amount of money they saved from not paying taxes: (1) retain a greater percentage of their earnings to reinvest in the business; (2) sell at low prices while still earning a profit; and (3) attract capital and labor more easily by offering returns and compensation that their taxable competitors could not match. In addition, taxable business enterprises argued that the absence of shareholders seeking immediate returns through dividends further enhanced the ability of tax-exempt organizations to reinvest their profits. Finally, some argued that the image of public benefit possessed by many tax-exempt organizations made it easier for those organizations to attract customers.

Congress responded to these concerns by enacting the tax on unrelated business income (now embodied in sections 511-515) and by denying tax-exempt status to so-called "feeder" organizations (i.e., organizations operated for the primary purpose of carrying on a trade or business for profit and distributing the profits to one or more tax-exempt organizations). The Congressional Committee reports on the Revenue Act of 1950 state Congress' concern clearly: "[T]he problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these ... organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes." H. R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); See also S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). With this determination, Congress rejected the "destination of income" test.

Although Congress in 1950 adopted the "unfair competition" policy rationale as the basis for the rejection of the "destination of income" test and the imposition of tax, it did not explicitly adopt "unfair competition" as the statutory standard for determining when the income of a tax-exempt organization would be taxable. Instead, Congress adopted a three part objective test based on whether a particular set of activities constitutes (1) a trade or business, (2) which is regularly carried on and (3) which is not substantially related, other than through production of income, to the organization's tax-exempt purposes. Congress felt that activities which met each of these three tests presented a sufficient opportunity for unfair competition to merit application of the unrelated business income tax to those activities. Still, the primary principle which Congress adopted as the fundamental policy justification for taxation was "unfair competition."

While the objective test was necessary as a general proposition, Congress wisely exempted certain specific types of activities that either did not present substantial opportunities for unfair competition or which it concluded should not be taxed for policy reasons. For example, Congress concluded that in the case of certain tax-exempt educational organizations, the unrelated business income tax would not apply if a "trade or business is carried on primarily for the convenience of the members, students, patients, officers, or employees of the tax-exempt organization." S. Rep. No. 2375, 81st Cong., 2d Sess. 29 (1950). Thus, the Senate Report stated that "[i]n the case of an educational institution, income from dining halls, restaurants and dormitories operated for the convenience of the students would be considered related income and, therefore, would not be taxable." Id. In addition, Congress specifically found that athletic activities of schools were substantially related to their educational functions. H. R. Rep. No. 2319, 81st Cong., 2d Sess. 109 (1950).

Congress thus concluded that such activities were such an integral part of a college or university's operations that they should be considered "substantially related." By explicitly providing that such activities did not meet one of the objective tests intended to identify "unfair competition" (i.e., lack of a substantial relation), Congress determined that such activities did not result in unfair competition with operations conducted by taxable businesses and therefore should not be subject to tax.

In the Tax Reform Act of 1969, Congress strengthened the unrelated business income tax in several respects, most notably by extending the application of the tax to virtually all tax-exempt organizations, including churches. However, as part of the 1969 Act, Congress also specifically reviewed certain broadcasting activities conducted by Loyola University and concluded, as it had with respect to college dormitories, dining halls and college athletics in 1950, that these activities, as defined in the 1969 Act, did not result in unfair competition with taxable business enterprises and therefore should not be subject to the unrelated business income tax. Rather than implementing this conclusion by focusing on the "substantial relation" prong of the three part objective test, as Congress had done in the case of student dormitories and college athletics, Congress addressed the Loyola situation carefully and directly by enacting current section 512(b)(15). The Senate Finance Committee Report explained the rationale behind the provision:

> The committee amendments provide that the unrelated business income tax is not to apply to a religious order or to an educational institution maintained by such a religious order that has operated an unrelated business, which provides services under a license issued by a Federal regulatory agency, for 10 years or more, if not less than 90 percent of the earnings from the unrelated business each year are devoted to religious, charitable, or educational purposes, and it is established to the satisfaction of the Secretary, or his delegate, that rates and other charges and services provided by such a business are fully competitive with and do not exploit similar businesses operating in the same general area. In such a case there are no competitive advantages obtained by the business from the exemption, and where the exempt organization has for a long time depended on this income, to make it forego approximately half of it would constitute a serious hardship.

S. Rep. No. 552, 91st Cong., 1st Sess. 70 (1969) (emphasis added).

This provision again represents a Congressional decision not to tax activities of a university which had long been conducted as an integral part of the university's operations and which, because of strict requirements that substantially all the net revenues from the activities be used to support educational purposes, could not result in "unfair competition" with taxable businesses.

I believe that this Congressional determination to focus on the presence of "unfair competition" continues to reflect the correct approach to the application of the unrelated business income tax to activities performed by colleges and universities. If Congress now chooses to expand the scope of the unrelated business income tax, under pressures to raise revenues, it is possible that the unfair competition standard would be expanded to cover many activities traditionally conducted by colleges and universities. Many activities conducted by colleges and universities arguably have counterparts in the taxable commercial sector. For example, university dining halls serve food to students for a price just as local restaurants do.

Similarly, university book stores sell books and other materials to students just as local book stores do. However, the mere similarity of function between certain university activities and comparable activities of taxable businesses should not result in decisions to tax income derived from such university activities for the following reasons:

(1) Such activities traditionally have been integral parts of college and university operations. Because of this traditional relationship, a clear distinction can continue to be drawn between activities conducted at a university as an integral part of its existence and activities conducted by taxable operations.

(2) Such activities, and the revenues derived from them, have become integral parts of the system of financial support for educational programs. Colleges and universities continue to rely on such revenues to supplement other sources of funding for student financial aid, faculty and staff salaries and improvements to educational facilities.

(3) Because such activities have traditionally been developed as an integral part of the educational mission, the operation of these activities by colleges and universities does not result in unfair competition. The fear expressed by Congress in 1950 of aggressive tax-exempt organizations threatening the profitability of commercial businesses does not apply to activities conducted by educational institutions which operate such activities as a continuing part of college culture and use any revenues derived from such activities to support education.

The problem at which the unrelated business income tax has been directed is that of "unfair competition." Congress has continued to follow a policy, at least with respect to educational institutions, of taxing only the income of activities which unfairly compete with taxable businesses, rather than activities which merely resemble the operations of taxable businesses. Such a scope for application of the unrelated business income tax has preserved many activities that have been traditionally conducted by colleges and universities as an integral part of their operations. I urge the Subcommittee to continue to adhere to the current scope of the unrelated business income tax as it applies to colleges and universities so that activities which have long conducted as integral parts of the educational mission are not subject to tax.

IV.

Conclusion:

Principles for Review of the Unrelated Business Income Tax

In conclusion, I urge the Subcommittee to adopt several principles as it conducts its review of the unrelated business income tax. Each of these principles is intended to broaden the context of the Subcommittee's review so that areas of concern to Loyola University, and very likely other colleges and universities, are given complete consideration.

A. Impact on Education.

Any expansion of the unrelated business income tax to reach a broader range of activities conducted by colleges and universities will reflect a decision to reduce funds available for education. Such a decision at this time could be devastating for many colleges and universities which are already suffering from the impact of reduced Federal funding for education. I am not aware of any college or university which could afford any further reduction in public support -- either cuts in direct support (reduced Federal spending) or "cuts" in indirect support (newly imposed taxes on university activities).

The revenues from certain commercial-type activities conducted by colleges or universities which are currently not subject to the tax on unrelated business income are directly providing support for students, faculty, staff and educational facilities -- in short, the educational function. Reducing these revenues by expanding the unrelated business income tax to apply to such activities would place the beneficiaries of such revenues in an almost impossible position. They would be required either (1) to look to government for money to replace the revenues paid to the Federal government in taxes or (2) to forego the educational activity until funds may be generated privately. For many less advantaged students, this choice could mean foregoing a college education altogether. For many academics, this choice could effectively require them to forego teaching opportunities and instead take employment in the private sector.

Therefore, I urge the Subcommittee to consider these potential impacts on education as it reviews the unrelated business income tax.

B. "Unfair Competition" as the Basis for Review.

The primary purpose of the unrelated business income tax as enacted by Congress in 1950 and expanded in 1969 was to prevent tax-exempt organizations from conducting activities which unfairly compete with taxable business activities. A secondary purpose was, at least implicitly, to raise Federal tax revenues. As the Subcommittee conducts its review of the unrelated business income tax, I believe that it should continue to adhere to the primary purpose of the provisions and avoid pressures to view the non-profit sector as a source of Federal revenues.

Failure to keep in mind the objective of preventing "unfair competition" would permit the possibility of extending the scope of the unrelated business income tax to activities which merely resemble certain operations performed by taxable businesses. As noted above, this analysis could result in the treatment of university dormitory operations as profit-motivated rental businesses, rather than as integral parts of student life, or the treatment of college athletic teams as professional sports teams, rather than as integral functions of the college or university experience. While at a superficial level, certain aspects of these activities resemble taxable commercial activities, the nature and context of such activities make clear that they are an integral part of college or university life which should not be viewed as unfairly competing with taxable businesses.

I urge the Subcommittee to continue to adhere to the principle of "unfair competition" as contained in the current unrelated business income tax provisions as the basis for its review of the tax as it applies to colleges and universities.

C. Expectations and Reliance of Colleges and Universities.

Many colleges and universities have conducted activities for many years which have not been subject to the unrelated business income tax. The income derived from these activities has, in many cases, become vital sources of funding for educational programs. Expanding the scope of the unrelated business income tax to reach these traditional activities would result in sharp reductions in the budgets of many colleges and universities which could not have been anticipated by university planners.

For example, Loyola University's broadcasting activities (noted above) have been conducted since 1922. These activities were not covered by the original unrelated business income tax provisions in 1950 and, in 1969, Congress specifically reviewed these activities and concluded that they did not result in any unfair competition with taxable businesses. During this period of Congressional approval, the revenues derived from these activities have become a major contribution to the budget of Loyola University. These revenues have been incorporated into the budgetary planning of the university and have softened the blow of the reduction of Federal spending for education. To require a reduction in these revenues by expanding the unrelated business income tax to apply to Loyola's broadcasting activities would cause an immediate and unanticipated reduction in Loyola University's budget for financial aid for students, salaries for staff and professors and capital improvements to educational facilities.

Therefore, I urge the Subcommittee to consider the fact that college and university budgetary plans have come to rely on revenues derived from activities which Congress has provided should not be subject to the unrelated business income tax. This has been especially true in recent years, as the Federal government has reduced its investment in higher education.

MAICO **HEARING AID SERVICE**

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June 15, 1987

Robert Leonard
Committee on Ways and Means
House of Representatives
Washington D.C. 20515

I have a major competitor in my area who enjoys tax-exempt status and I deeply resent the unfair competition.

Thank you for your concern.

Sincerely,

Jeannette Kerr

Jeannette Kerr

Testimony of Reid J. Lifset
Department of Political Science
Massachusetts Institute of Technology

My name is Reid Lifset and I am Ph.D. candidate in political science at the Massachusetts Institute of Technology (MIT). I am testifying in my capacity as student of nonprofit organizations.

My interest in the issue of competition between nonprofit organizations and small business results both professional experience and scholarly research. From 1979 to 1983 I worked for National Public Radio (NPR) in Washington, D.C. where I helped to develop plans for a for-profit subsidiary -- NPR Ventures -- whose purpose was to earn profits to offset the impact of the Reagan budget cuts. Subsequently, I left NPR and returned to school to pursue my doctorate. During the summer of 1985 I was awarded a John D. Rockefeller III Fellowship at the Program on Nonprofit Organizations at Yale University. This fellowship has allowed me to research the history and politics of competition between nonprofits and small business.

By testifying, I hope to provide the Oversight Subcommittee with some information that will broaden the framework in which the current controversy over unfair competition between nonprofit organizations and small business is conducted. It is not my intent to attempt to adjudicate claims of unfairness or to propose policy solutions. The numerous advocates who have testified before the Subcommittee are better equipped to deal with those matters. It is my "comparative advantage" to provide some historical and analytical perspective on this contentious issue.

In my testimony, I will discuss three factors that are important to understanding the genesis of the current controversy over unfair competition. The first factor is the confusion of charities with nonprofit organizations: charities comprise only a small part of the nonprofit sector. To discuss the unfair competition issue in terms of charities is to misunderstand the very nature of the nonprofit sector. Second, we cannot understand this debate nor work towards policy solutions without knowing that nonprofit commercial activity results in part from the expansion of the nonprofit sector due to government policy and the subsequent contraction of that government support.

Third, by providing some history of nonprofit commercial activity and of conflict between nonprofits and small business, I will demonstrate that this is not a new issue. Small business has organized to change tax policy regarding nonprofit organizations before -- just after World War II. But the changes wrought in the tax code were not just a result of small business complaints or of nonprofit abuses. They were also a product of the times. The need to reconvert the American economy from wartime to peacetime footing had a strong impact on business-government relations in the early postwar period.

Nonprofits vs. Charities

The standard conception of charity held by most members of the public has two components. On the revenue side, charities are supported by donations. On the expenditure side, they provide goods and services to those who are less well-off. Typically, the services are provided to recipients for free or at below cost prices.

But there are many nonprofit organizations that do not fit that description including universities, museums, symphonies, hospitals and nursing homes. These sorts of institutions charge fees for their services. Frequently their clientele are not the poor or disadvantaged. What is interesting about universities and cultural organizations is that their nonprofit status is really quite uncontroversial. Even the most embittered critic of nonprofits does not advocate converting these organizations into for-profit organizations nor do they propose denying tax exemption to colleges simply because nonprofit services are not provided for free. Few of us have problems with the fact that students pay tuition for their education.

My point here is that a simple definition of nonprofits as organizations that do not receive fees for services does not jibe with what we all know about the institutional landscape in American society. So what is the appropriate definition of a nonprofit organization? Before I answer that question let me indicate why one common definition is not tenable.

Some suggest that nonprofit organizations are those organizations whose revenues do not exceed their expenditures. That is, they do not make a profit. That definition is both too broad and too narrow. It is too broad because it includes failing businesses. Clearly, there is a difference between a business experiencing hard times and an organization whose goal is deliberately not one of making profits.

The don't-make-a-profit definition is also too narrow because it precludes organizational saving by nonprofit organizations. Like small businesses, nonprofits experience ups and downs in revenue. When the economy stagnates, typically so does charitable giving. Retention of net income across years allows nonprofits to ride out these sorts of fluctuations. Such savings also allow nonprofits to save for capital purposes like building dormitories at universities, new wings at museums or replacing old transmitters at public TV stations.

Most scholars and policy analysts that study nonprofit organizations seem to have agreed that what makes a nonprofit organization nonprofit is that there are no shareholders who can take home the profits. That is, nonprofit organizations cannot distribute net earnings to those individuals that formally exercise control over the organization. This definition is present in some parts of the legal code that deal with nonprofit organizations and it is one which economists who study nonprofits find most persuasive. This prohibition is called the nondistribution constraint.

According to this definition and to current tax law, we find nonprofits operating in diverse segments of American society?

* social welfare services
* arts and culture
* higher education
* health care: hospitals & nursing homes
* the media, especially broadcasting
* trade associations
* fraternal organizations and social clubs
* public interest groups and political pressure groups
* foundations and related funding agencies.

The point here is that nonprofit organizations have always encompassed a broader set of institutions than charities. To characterize them narrowly as organizations only legitimately operating to help the disadvantaged is add confusion to the current debate. The broader character of nonprofit organizations cuts both ways in this debate: the fact that a nonprofit organization obtains revenue through other than donative sources does not prima facie make illegitimate. On the other hand, nonprofit status does not confer the privileged standing that a purely charitable organization is due.

I want to introduce one more set of distinctions before I turn to the history and politics of competition between nonprofits and small business. The activities of nonprofit organizations that many find controversial are not all of the same sort. Broadly speaking, there are three categories of commercial activities: unrelated business activities, fees-for-services and related commercial activities.

1) Unrelated business activities -- the purpose of these activities is unrelated to the basic mission of the

nonprofit. By mission, I simply mean the basic purpose of the organization. For example, my university, MIT, is developing a real estate project that will yield it profit with which MIT can support its educational and research activities. Note here that the key purpose is the subsidization of the basic mission through the pursuit of profits in the market. Unrelated business activities are taxed either through the Federal unrelated business income tax or through conventional corporate income taxation if the activity is pursued through a separately incorporated, arms-length subsidiary.

2) Fees-for-services -- The services in these instances are mission services, but unlike charities, the recipients of the services are also the source of financial support. As I mentioned above, many traditional nonprofit organizations, charge for their basic services and, more and more nonprofits are beginning to move in this direction. University tuition and fees for psychological counseling or job training fit in this category.

3) Related commercial activities -- these activities are the source of much of the current controversy, especially as it regards the tax code. These sorts of activities range from university-operated laundries to museum gift shops to the YMCA's health clubs.

The Problem

Like many public policy issues, the problem of unfair competition is not really one problem but several: the problem of the impact of competition of nonprofits on small business, the problem of declining revenues for nonprofit organizations, the problem of the efficient institutional configuration for our economy, the problem of securing sufficient tax revenues and the problem of feasible regulation and tax administration. I will not attempt to address all of those problems here; I will focus on the problems for small business and for nonprofit organizations.

For small business, the problem seems clear: organizations whose social purpose is entirely unrelated to commerce are posing a competitive threat to their livelihood. Those competitive rivals sometimes have what appears to be special and unfair advantages: exemption from federal and state income taxation, from property and sales taxes and from a variety of government regulations. In addition, the nonprofit rivals have an intangible advantage -- community good will arising from their public service activities. This competition is sometimes threatening, apparently unfair and even at times seemingly illegitimate.

For nonprofit organizations, there are two problems. The first is declining resources coupled with increased demand. The financial support for nonprofit organizations is declining just as the government and the society are expecting nonprofits to pick up the slack caused by cuts in government spending. The second is mixed messages coming from policymakers and society at large about the direction that the sector should take.

With regard to declining revenues, the primary source of this problem is the federal budget cuts begun in the early 1980s. To understand why this is so, we need to have a better grasp of the sources of revenue for nonprofit organizations. Fortunately, there is a great deal of information that has recently come available on this particular topic. The Urban Institute has been studying the changing role of nonprofit organizations in the US and especially the relationships between these organizations and government in a large scale research project for the past 6 years.

According to their recent findings,[1] the single largest source of revenue for nonprofit organizations is government. That is because over the past 3 or 4 decades federal and state governments have increasingly turned to nonprofit organizations as a means for the delivery of public services. The second most important source is fees, dues and charges. Charitable giving is only third in rank of share of total funding. See the attached chart for further information on sources of funds for nonprofits.

Thus, when the federal government cuts back its support, nonprofits feel the crunch. According to the Urban Institute, the budget cuts in the period 1982-1986 produced revenue losses to nonprofit organizations (exclusive of Medicare and Medicaid) of approximately $23 billion below what would have existed had FY 1980 spending levels been maintained. That translates into an approximate annual loss of $4.6 billion dollars a year.

Now at the same time the federal government has cut back on direct governmental support in areas in which nonprofits are active. In the same period, those cuts have amounted to about $70 Billion. This has generated increased demand for service provision by nonprofits. Many policymakers, including President Reagan have explicitly looked to nonprofit organizations to furnish the services previously provided by government. So, on the one hand, direct support of nonprofits by government has decreased while, on the other, demand for nonprofit services has increased.

Many policymakers argue that government expenditures needed to be cut back and it is the role of private philanthropy to support health, welfare, culture and the arts. The Urban Institute's research indicates that private giving was able to make up for some of the budget cuts but giving could not do the whole job. Charitable contributions made up for only 57% of the direct revenue losses sustained by nonprofits and only 7% of decrease in government spending in the areas of interest to nonprofits. Looking to the future, in order to offset the budget cuts that the administration has proposed for FY 1987-1989, private giving would have to grow at a rate of 700 to 800% higher than its peak rate in recent years to meet the service gap. To offset the direct revenue losses, giving would have to grow at a rate 200% to 300% higher than its recent peak rate. This combination of increased demand, decreased federal revenue and limited growth in private giving is compounded by the recent revision of the tax laws. The new flatter tax rates decrease the economic incentives for charitable giving. At the same time, the abolition of the charitable deduction for nonitemizers and the increase in the floor for itemizers further reduces tax incentives for giving. Nonprofits are getting squeezed all around.

In some related and very recent research, the Urban Institute has shown that most of the reductions in federal support have been offset by increased fees-for-services by nonprofits.[2] This recent finding is particularly important for the competition issue. The increase in revenues does not come from unrelated business income but from the other two sorts of commercial revenue I discussed earlier. Some of the fees for services are charges for mission activities like social welfare services. In these sorts of situations, the nonprofit organization typically charges its existing clientele for services previously provided for free or the nonprofit shifts its target clientele to a more well-off constituency that can pay for the services. The impact on the clientele of nonprofits is a disturbing finding but not directly relevant to the controversy facing the Subcommittee. It is the related-but-not-core services that stirs the current debate and the Urban Institute data provides some national level corroboration for the problems that prompt these hearings.

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[1] The Urban Institute's Nonprofit Sector Project has generated over 40 publications. The material that I draw on in this testimony can be found in Alan J. Abramson and Lester M. Salamon, The Nonprofit Sector and the New Federal Budget (Washington, D.C.: The Urban Institute Press, 1986).

[2] Carol J. DeVita and Lester J. Salamon, "Commercial Activities in Human Service Organizations." in Working Papers of the 1987 Independent Sector Spring Research Forum. (Washington, D.C.: The Independent Sector, 1987).

The Urban Institute project found that as of 1981 only 6% of nonprofit organizations revenue came from either related commercial activities or unrelated businesses. Less than 1/4 of the agencies surveyed indicated that they engaged in such activities. When resurveyed 2 years later, the increase in such activity was not significant.

By contrast, fees for services accounted for 28% of all revenue. A full 70% of all nonprofits surveyed reported receiving this sort of income. And fee income increased by 21% in the following survey 2 years later.

The Urban Institute's database does not include universities or hospitals because the researchers chose to focus on parts of the nonprofit sector where there is a considerable lack of data. This exclusion somewhat understates the presence of unrelated arms-length business activities. My research indicates that it is universities, hospitals and cultural organizations that seem to be engaging in most of this sort of commercial enterprise. This raises a point deserving emphasis: the different parts of the nonprofit sector are engaging in different sorts of commercial activity. The nonprofit world is not all of a piece.

Before discussing the history of nonprofit commercial activities, I want to briefly mention one more factor that influences nonprofit behavior. In the 1980s, there has been a positive shift of public attitudes towards business and the market. In public policy this is reflected in the Administration's penchant for privatization. In the world of nonprofit organizations, this shift of attitudes has been manifested through calls for more "business-like" management -- "doing good by doing well" -- and more importantly through pressures by funders for nonprofit organizations to become less dependent on foundation and government grants. Many foundations even attach requirements to grants that direct recipient organizations become self-sustaining. And it is preceisely commercial activity that is the means by which they are to become self-sustaining. So while business leaders complain about unfair competition and government leaders cut funds, philanthropic leaders pressure for entrepreneurial initiatives.

History

While I have painted a picture of nonprofit organizations moving toward commercial activities in response to changes in government policy and public attitudes, nonprofit commercial activity did not begin with the Reagan budget cuts. Nearly a century ago (in the 1890s), nonprofit organizations were forming for-profit subsidiaries to subsidize their primary activities. I am sure that while many people have heard of the Boston Pops, but most did not know that one of the reasons that it was formed was to support the Boston Symphony Orchestra.

Unfortunately, little statistical data exists that documents the extent of commercial activity by nonprofits until the last decade. What we do know about, however, is the evolution of tax treatment of nonprofit commercial activities.

There are three important elements to the history of this issue. First, there is the change in tax policy and the politics that have accompanied those changes. Second, there is the broader political environment in which the tax policy issues were debated -- the predominant attitudes towards nonprofits in general and philanthropic foundations in particular. The prevailing relationship between business and government set the political context as well. Finally, there is role of government funding -- its expansion and contraction -- in stimulating the search for new sources of funding for nonprofits.

Key to understanding the changes in the tax treatment of commercial activity is the test used by the IRS to decide whether commercial income is taxable. Prior to 1950, the government employed a destination test. Using this criterion, tax exemption depended on the destination of the income produced by a business rather than by the source of income.

Corporate income is taxed twice. First, the corporation pays taxes on its net income. Then, shareholders pay taxes on the dividends. According to the destination test, nonprofit organizations owning and operating businesses, paid taxes at neither point. Thus, if a nonprofit organization owned a macaroni company, for example, and if the profits of that macaroni company were used solely to support the mission activities of the parent nonprofit organization, the macaroni company would pay no income taxes nor would the nonprofit pay taxes on the dividends it received.

In 1950 the test was changed by Congress to one of relatedness. Rather than asking whether the profits were destined for a nonprofit organization, the IRS began to ask whether or not the income producing activity was related or unrelated to the exempt (or what I have been calling the mission) activity of the organization.

The problem of commercial activity by nonprofit organizations seems to have come to public consciousness and under political scrutiny rather slowly. Keep in mind that the permanent national income tax was established in 1913 so that the question of what sort of charitable activity could be legitimately exempted from federal taxation can be dated to that point. Prior to World War II, the most important policy deliberations on commercial activity occurred in the Supreme Court in 1924 in the Trinidad v. Sagrada[3] case. The Court held that a Philippines religious order could sell wine, chocolate and other incidentals to churches, missions, and other related agencies. The ruling attracted little public attention and it established only an ambiguous precedent for future cases because the religious order was not engaging in sales to the public nor was in competition with businesses.

However, in a 1938 case, Roche's Beach v. Commissioner,[4] the Circuit Court broadened the criteria for allowable commercial activities and clearly established the destination test which became the working standard for the Bureau of Internal Revenue in these matters.

This apparently well-established policy began to unravel just after the war when abuses of the tax exempt status of nonprofit organizations began to receive wide spread attention. The most notorious controversy revolved around the NYU Mueller Macaroni case. A group of wealthy New York University Law School alumni purchased the C.F. Mueller Company, the country's largest manufacturer of noodles, macaroni and pasta. The alumni, hoping to provide a source of income which would allow their alma mater to achieve enhanced standing in the academic community, acquired the company using techniques that we would now call a leveraged buy-out.

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[3] 263 U.S. 578 (1924).

[4] 96 F.2d 776 (2d Cir. 1938).

While the action differed little from the pre-war cases of nonprofit commercialism, the reaction here was instantaneous and vociferous. Fortune Magazine and The New Republic editorialized about the scandalous behavior of charities and one Congressman thundered that "if something is not done ... the macaroni monopoly will be in the hands of the universities."

Despite the apparently sudden hew and cry over the dangers of unfair competition, the NYU case was not a sudden development. Congress had been holding hearings on commercial activities of nonprofit organizations since 1947. According to Congressional testimony, colleges and universities were involved in extensive sale-lease back operations with department stores. For example, in the first widely publicized case, Allied Stores sold tha real estate associated with some of its stores to Union College. The college then leased the property back to the department store. The property was sold at above market costs which the college recouped because it paid no real estate taxes or income taxes on the transaction. The department store benefited both from an above market sales price and a below market rental rate.

This arrangement spread rapidly and by 1950 Yale had sale lease-back arrangements with Macy's in San Francisco and Frank & Seder in Philadelphia; Harvard with Gimbel's; Oberlin College with Montgomery-Wards, Sears, and Woolworth's; and the University of Pennsylvania with Lit Brother's in Philadelphia.

At the same time, other nonprofits owned a variety of commercial enterprises ranging from airports to gas stations to china companies to leather goods manufacturers. The policy concerns were several: some Congressmen worried about lost tax revenues, some about unfair competition, finally others about the abuse of nonprofit status. With respect to abuse of tax privileges, the controversy in the late 1940s differed from the current debate. At that time a variety of businesses had set up foundations and charitable trusts specifically to avoid taxation. Many of the businesses preceded the charities that they were supposed to support. I think that our current controversy lacks similar villains. What we face today is period of transformation and flux in the boundary between the public and private sectors, rather than simple abuse.

While it seems quite understandable that Congress initiated reforms in 1950, a more careful examination indicates that the outcome was not predestined. As a political scientist, I am always skeptical that public needs or public outcry automatically translate into government action for reform. My professional skepticism lead me to some interesting information.

First, I should note that in spite of the apparent abuses that I have mentioned, the critics of nonprofit commercial activity were facing a formidable set of political rivals -- representatives of the Ivy League schools, major Church denominations, hospitals, and charities testified before Congress about their need for additional income and the propriety of their revenue-raising activities.

A major advocate of changes in the tax treatment of nonprofits was an organization called the National Tax Equality Association or NTEA. In fact, one might say that it was the predecessor to a contemporary organization, the Business Coalition for Fair Competition, active in the current policy debate. Like the Business Coalition, the National Tax Equality Association was concerned about the competitive threat that nonprofit organizations posed for small business.

But why did the NTEA succeed? There seem to be two background factors at work. First, just after World War II, business political groups were especially well organized. Many business leaders were concerned about how the US would make the transition from a wartime economy to a peacetime prosperity. They feared that the US would return to Depression conditions or at least repeat the postwar recession that followed World War I. In addition, the Federal government had become involved in the economy in an unprecedented fashion during the war. This involvement ranged from wage and price controls to actual ownership of aluminum factories and oil facilities. Business groups wanted to be sure that government retreated from this high level of intervention in the economy and that planning for reconversion to a civilian economy occurred so as to avoid economic chaos. The Committee for Economic Development (CED) was formed in part to pursue these goals. The CED formed an alliance with the US Chamber of Commerce and the National Association of Manufacturers to press their concerns in Washington.

The controversy over competition between nonprofits and business took place in this context. Business groups were highly active at this point and Congress was receptive to the sorts of concerns about the appropriate relationship between the public and private sectors raised by these groups. And the nonprofit competition issue resonated with these concerns.

The controversy and the resulting changes in the tax law in 1950 was really the only important political controversy over nonprofit commercial activities prior to the current debate. In 1969, Congress made some minor changes to the definition of unrelated income. The 1969 Tax Act was of crucial importance to the nonprofit sector but it was composed almost entirely of punitive regulations focused specifically on foundations.

There is one more piece of history to include to understand how we got to where we are today. That piece is the government-stimulated expansion of the nonprofit sector in the postwar period. Earlier in this testimony I cited some statistics that indicated that government funding is the largest source of income for the nonprofit sector. This reliance on the public sector is the product of changes in government policy in the last 30 years.

In the social welfare field this is mostly the product of changes to the Social Security Act in the 1960s and the early 1970s which allowed nonprofit social service organizations to receive Federal funding. That change stimulated the rapid expansion of nonprofit organizations working in that field.

In arts and culture, the advent of the federal, state and local government arts funding through such agencies as the National Endowment for the Arts, likewise stimulated the growth of museums, symphonies, dance companies and so on.

In health care, the change in the industry and the nonprofit providers, arose from a different sort of funding increase. The rapid increase in the number of Americans covered by medical insurance and the resulting increase in third-party payment to health care providers stimulated an enormous expansion of the health care sector. Some of that expansion of insurance resulted from Medicare and Medicaid. The rest came from private medical insurance. Either way, the third party payment system provided incentives for investor-owned for-profit hospital chains to enter the industry.

In the social welfare and arts fields, government policy led to commercial activity through a two-stage process. First, the various nonprofit sectors expanded. Then in the 1980s, when government funding was reduced, the organizations sought to find new sources of funding to replace government money. As I discussed earlier, the search for new sources of funds led to commercial activities.

In the health care field, the stimulus has not so much been the withdrawal of funding that has stimulated commercial activity -- although that has been a factor in some case -- as it has been the advent of competition from for-profit rivals.

The history of nonprofit commercial activity and of battles between nonprofits and small business tells us several things. It tells us that political conflict over this issue does not occur in a vacuum. It tells us that the nonprofit commercial activity and the resulting competition cannot be understood without knowing what forces are shaping the nonprofit sector and the industries in which they operate.

Conclusion

In this testimony, I have attempted to provide a some background with which to frame the current debate. Let me end by drawing a few morals.

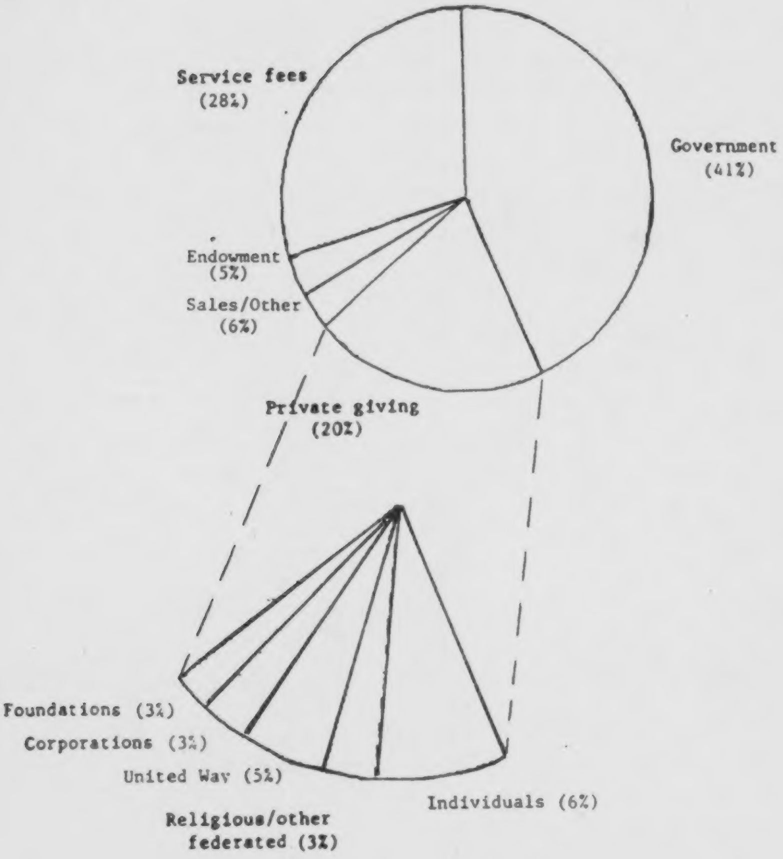
First, it is important to recognize that not all nonprofit organizations are charities and it is therefore not legitimately a revelation to discover upon investigation that many nonprofits do not meet the standards of charitable behavior. If Congress and the public decide that tax exemption is only suitable for charitable organizations in the narrow sense of the term, so be it. But we should not condemn many other sorts of nonprofit organizations for straying from a standard of organizational behavior that they have never claimed to pursue.

Second, we should distinguish between the different sorts of commercial activities: unrelated business activities, fees-for services and related commercial activities. There is a great deal of confusion between fees-for-services, on the one hand, and related and unrelated commercial activities on the other. Labeling all of these income sources as commercial and censuring nonprofit organizations for obtaining revenue through other than donative means confuses the policy issues. There is an important difference between a university charging tuition and the same university selling research services.

Third, keep in mind that this debate is not just about fairness. It is also about the manner in which public services will be delivered in America. Larger changes in public policy -- privatization and reform of the tax code to name just two -- have profound effects on both the nonprofit sector and the small business community. To ignore the larger policy environment when devising solutions to the unfair competition controversy is to potentially lay the seeds for future conflict on this same issue.

SOURCES OF INCOME FOR
NONPROFIT HUMAN SERVICE ORGANIZATIONS,
1981

(n = 2,304)



Source: The Urban Institute Nonprofit Sector Project, round I survey. Published in DeVita and Salamon, "Commercial Activities in Human Service Organizations." See Footnote 2 above.

MID-KANSAS
Acousticon, INC.
2302 EAST CENTRAL
WICHITA, KANSAS 67214

Telephone 267-4973

June 20,1987

Dear Sirs,

This letter is in regard to the the hearing aid services being offered to the public in our area by so called "NON PROFIT" organizations.

These organizations namely, Wichita State University, the Institute of Logopedics, and other organizations are in direct competition with " FOR PROFIT " companies such as my own. This makes it very difficult to compete with them when they have at thier disposal, tax payer's money as well as private donations, and enjoy a tax exempt status! We, as the individual dispenser certainly do not receive these benefits; Sir, please tell me what is fair about a condition in which one "company" fits and sells hearing aids (for profit), yet is not required to pay taxes, and another "company" who fits and sells hearing aids (for profit) and has done so for many years, yet does have to pay taxes.

The, general perception of a non profit organization. is that they receive most of their income from contributions and tax revenues. In fact, according to the reports filed with the I.R.S. these entities derive approx. 76% of their income from sales, and only about 23% from their gifts and dues. We also realize that some of the sales may be charges for things that are clearly part of the "non profit's" charitable, educational, or cultural mission serving the needy.
However, the competition created by many of these sales activities is unfair and should be dealt with.

In specific the unfair aspects are:

1.The nonprofit may pay no Federal, State or local taxes on profits generated from sales of products and services.

2.The nonprofit may be tax supported.

3.The non profit may use non profit mailing rates in its sales promotion activities.

4.The above may be exempt from normal taxes borne by most businesses such as sales tax, inventory tax, and property tax.

5.The above may operate using rent free facilities and a workforce paid in part or in whole by public funds.

MID-KANSAS... the company that repairs all makes of hearing aids

ACOUSTICON...SINCE 1902...WORLD'S FIRST ELECTRICAL HEARING AID

All of these things combined are making it more and more difficult for the independent business man, in particular, the Certified Hearing Aid Audiologists, and State Licenced Dispenser's who built this business by making people"HEAR". It is definitly unfair when the above mentioned agencys are able to sell their hearing aids at a non-competetive price due to lack of overhead expenses, such as ones mentioned 1. thru 5. above.

I feel sure that this committee will find thru it's investigation that the contributions made by small independent business to the community, is definitly worth protecting. And that the threat of unfair competition will be dealt with effectivly.

Sincerely,

Terry L. Bollinger

Terry Bollinger
Certified Hearing Aid Audiologist

cc: Robert J. Leonard, Chief Counsel Comm. on Ways and Means
Rep. Dan Glickman
Senator Nancy Kassebaum
Senator Bob Dole
Mr. James Lovell, National Hearing Aid Society

Arent, Fox, Kintner, Plotkin & Kahn

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August 5, 1987

The Honorable Jake Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Re: National Association of College Stores Response to Subcommittee Information Request at Recent UBIT Hearings

Dear Congressman Pickle:

We write you as Chairman of the Ways and Means Oversight Subcommittee on behalf of our client, the National Association of College Stores ("NACS"), on the subject of Unrelated Business Income Tax ("UBIT") in response to your information request at the Subcommittee's recent UBIT hearings. We ask that this letter be made a part of the Subcommittee Record for these hearings, and are providing the requisite number of copies. We are also enclosing with this letter various tabbed documentary and other exhibits, which we also request be made a part of your Subcommittee's files on this matter. We have provided copies of this letter and the enclosed exhibits to Subcommittee Counsel Russlyn Guritz and Vanessa Clark.

For your information, NACS has some 2,625 college bookstore members encompassing virtually all public and private university and community college bookstores in the United States, along with several hundred privately owned, small business, for-profit stores located off but near the nation's campuses. While NACS supports the position advanced by the American Council on Education, NACS believes it important to supplement the general information provided by the higher education community with more specific data about the college bookstores.

During last June's UBIT hearings, NACS became very concerned over Subcommittee Member and staff frustration arising from the absence of concrete factual information about non-profit, tax-exempt institutions' activities subject to small business unfair competition complaints. This frustration seemed to focus Subcommittee attention away from perhaps the most critical higher education UBIT question of all, namely the extent to which subjection of presently tax-exempt activities to taxation through changing UBIT laws will increase higher education costs at a time when federal and state higher education spending on student aid and institutional support is declining and all other campus costs are rising far faster than inflation.

College bookstores seem to be receiving unusually harsh, and in our view, unwarranted criticism on the UBIT issue. College bookstores in fact traditionally take precautionary measures to avert UBIT problems and cooperate with IRS compliance activities. Indeed, an enclosed recent NACS-sponsored Coopers & Lybrand Study of campus auxiliary activities concludes that many campuses intentionally refrain from engaging in any UBIT activities for fear of jeopardizing their tax-exempt status; while those which do engage in such activities report and pay UBIT.*/ Jim Crowson, Vice Chancellor for Legal Affairs of the University of Texas System in Austin, made this very point to you at the June 29 Subcommittee hearings.

In addition, NACS is especially sensitive to the competition issue since nearly 13 percent of NACS member bookstores are privately owned, for-profit small businesses located off but near the campus. For this reason, NACS has been in the forefront of organizations adopting recommended guidelines for member institutional business activity which are likewise enclosed here.**/ College bookstore criticism arising before and during the hearings therefore seemed not only unusual but most unfair, since NACS private sector store members seldom if ever complain about competition in the sale of merchandise even though they face it everyday from their non-profit, tax-exempt counterparts on campus.

I. Description of Enclosed Documentation and Summary of the Conclusions It Supports

As a result of the hearings and pursuant to your own further information requests, NACS has identified and compiled relevant information in its possession with the objective of providing it to assist the Subcommittee's deliberations. NACS also accelerated the initiation date of its own UBIT-Competition Survey of on-campus bookstores designed to obtain much of the same information you requested at the hearings so that the responses from at least some NACS members could be made available for Subcommittee use. We have therefore enclosed copies of the Survey responses representing over 20 percent of all domestic NACS on-campus store members.***/ We believe these partial results accurately reflect the total industry. You will note the extremely small incidence of unfair competition complaints. Those which do arise are aimed primarily at computer sales and school supplies, which NACS believes should be sold on campus as tax-exempt, educational necessities. In addition to these Survey results, we are also enclosing the following documents:

*Recently Adopted NACS Guidelines on Competition.****/

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*/ COOPERS & LYBRAND, CORPORATE STRUCTURAL ALTERNATIVES IN HIGHER EDUCATION (Nov. 1986) (Ex. 15) at 24, 26-29 ("COOPERS & LYBRAND STUDY").

**/ Exhibit 2.

***/ Exhibit 1.

****/ Exhibit 2.

*Statements of former Congressman and current New York University President John Brademas and Texas State Representative Wilhelmina Delco from Austin (who chairs the Texas House Higher Education Committee) presented during the last two Congresses at House Postsecondary Education Subcommittee hearings which you attended, describing the serious economic crisis facing higher education as the result of increased student costs accompanied by decreased government higher education spending. */

*Excerpted Senate and House Education Committee Report statements from the last Congress describing the serious higher education student financial problems identified in the 1986 Higher Education Reauthorization Act.**/

*A May 17, 1987 Newsweek article which reveals that the student educational cost problems continue to mount unresolved. ***/

*A recent higher education monograph describing the adverse effects of 1986 tax legislation on higher education student and institutional costs. ****/

*A 1986 NACS-sponsored study of the higher education student financial profile, showing how little discretionary income most students really have.*****/

*A 1986 NACS-sponsored study of student book purchasing characteristics and attitudes towards college bookstores which indicates that college store book prices are perceived to be so expensive that they may restrict student ability to spend limited discretionary income on other items. */

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*/ Observance of the 20th Anniversary of the Higher Education Act: Hearing Before the Subcomm. on Postsecondary Education of the House Comm. on Education and Labor, 99th Cong., 1st Sess. (1985) 2-11 (statement of the Hon. John Brademas) and 55-58 (statement of the Hon. Wilhelmina Delco, Texas State Representative and Chairperson of the Texas House Committee on Higher Education); and Reauthorization of the Higher Education Act: Hearing on H.R. 5240 Before the Subcomm. on Postsecondary Education of the House Comm. on Education and Labor, 98th Cong., 2d Sess. 102 (statement of Rep. Delco). Exhibits 3 and 4.

**/ S. REP. NO. 296, 99th Cong., 2d Sess. 1; and H.R. REP. NO. 383, 99th Cong., 1st Sess. 1. Exhibits 5 and 6.

***/ Fuming Over College Costs, NEWSWEEK, May 18, 1987 at 66-71. Exhibit 7.

****/ R. ANDERSON & J. MEYERSON, FINANCING HIGHER EDUCATION: STRATEGIES AFTER TAX REFORM (1987). Exhibit 8.

*****/ COLLEGE STORES RESEARCH & EDUCATIONAL FOUNDATION, III STUDENT WATCH COLLEGE CONSUMER SURVEY, FINANCES: HOW DO STUDENTS PAY AND WHAT ARE THEIR FINANCIAL GOALS? (1986) ("STUDENT WATCH, VOL. III). Exhibit 9.

*A 1986 NACS-sponsored study of what and how much students actually purchase in the college bookstores, which shows that they spend so little on so-called non-educational items in campus bookstores (and in fact spend far more off campus) partly because of higher prices which undercut any unfair competition allegations. **/

*A 1985-86 NACS Merchandising/Operating Survey which shows how little margin college bookstores receive on textbooks, requiring them to charge higher prices on other items to subsidize low textbook prices; and the virtually nonexistent advertising or other promotional activities college bookstores engage in; plus a 1984-1985 NACS Product Survey showing that the overwhelming majority of campus bookstore customers come from the student, faculty and staff community. These two Surveys reinforce the point that the stores pose no competitive threat.***/

*A recent NACS large campus bookstore survey which shows not only that larger bookstores presently subject to the strongest competition criticisms rely almost solely upon books, school supplies and insignia items for most of their revenue, but also that a number of them already pay income taxes or else operate at a financial loss and thus incur no tax liability. ****/ Please note that individual store names have been deleted to assure confidentiality promised when this Survey was conducted.

*The recent Coopers & Lybrand Study referred to above and initiated at NACS request which reveals, among other things (i) the broad diversity of college bookstore structures which makes standardized tax accounting and reporting extremely difficult at best; (ii) that most unfair competition claims tend to arise from campus sale of discounted computers to

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*/ COLLEGE STORES RESEARCH & EDUCATIONAL FOUNDATION, I STUDENT WATCH COLLEGE CONSUMER SURVEY, BOOKS: WHAT DO STUDENTS READ, WHAT DO THEY BUY -- AND WHY? (1986) ("STUDENT WATCH, VOL. I). Exhibit 10.

**/ COLLEGE STORES RESEARCH & EDUCATIONAL FOUNDATION, II STUDENT WATCH COLLEGE CONSUMER SURVEY, SHOPPING: WHERE DO STUDENTS SHOP, AND WHAT DO THEY BUY? (1986) ("STUDENT WATCH, VOL. II"). Exhibit 11.

***/ NATIONAL ASSOCIATION OF COLLEGE STORES, 1985-1986 MERCHANDISING/OPERATING SURVEY (1987); and 1984-1985 COLLEGE STORE PRODUCT SURVEY (1985). Exhibits 12 and 13.

****/ NATIONAL ASSOCIATION OF COLLEGE STORES, 1985-86 LARGE STORE GROUP OPERATING SURVEY (1987). Exhibit 14.

> students and faculty only, which Congress should be actively encouraging for critical national policy reasons rather than penalizing through subjection of such transactions to taxation; and (iii) the legal requirement in many jurisdictions that campus auxiliaries not incur financial losses.*/

We believe that the enclosed materials support several significant conclusions.

First, subjection of any campus bookstore or other auxiliary revenues to taxation will increase student educational costs at a time when student and student family capacity to absorb such costs has never been weaker.

Second, college bookstores pose no unfair competitive threat to the private sector. They engage in no predatory pricing, and in fact tend to charge equivalent and often higher prices than off-campus stores. They engage in virtually no advertising or other promotional activities off the campus, and rely overwhelmingly upon sales of basic educational items for revenue. This explains why campus bookstores receive so few actual unfair competition complaints from private businesses, especially from the many NACS private sector members competing against them daily.

Third, a number of campuses presently pay UBIT on certain campus bookstore and other auxiliary revenues. Those which incur operational financial losses (such as at least one store cited so critically during the hearings) of course have no tax liability. This suggests that present UBIT laws, at least as applied to college bookstores, function well and warrant little if any change.

We have elaborated below on each of the above conclusions and identified certain other important policy concerns which warrant careful Subcommittee scrutiny before any legal changes are proposed. We would preface our additional comments, however, by reiterating Congressman Dorgan's concerns expressed during one of the June 29 health care panel presentations, when he cautioned against any change in UBIT law before completing a careful assessment of the economic harm likely to result from any such changes. As he correctly pointed out, the private sector has yet to prove its capability of meeting essential social needs presently served with considerable success by non-profit, tax-exempt institutions. Assuming that any change in UBIT laws increases the cost of meeting these needs through subjection of revenue-raising activities by these institutions to taxation, then we suggest that the Subcommittee err on the side of caution in proposing such change before determining how adversely delivery of these services will be affected. As seen below, NACS concerns about its own campus store member ability to continue providing essential services in the face of legal change seem especially well-founded.

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*/ COOPERS & LYBRAND STUDY. Exhibit 15.

II. Adverse Effects of Any Change in Present UBIT Laws On Campus Bookstore Activities

A. Subjection of Tax-Exempt Educational Sales to Taxation by Changing Present UBIT Law Increases Higher Education Costs at a Time When the Campus Community Has Never Been Less Able to Afford Such Increases.

Regardless of whether one favors or opposes present UBIT laws, one thing is virtually certain. Any legal change which subjects presently tax-exempt transactions to taxation will increase transaction costs and thus result in higher prices. Applied in a higher education setting, this means that students, faculty and staff will pay higher prices at a time when the campus community, and particularly the students, confront perhaps their worst financial crisis ever and are simply not in a position to bear such increases.

Addressing the House Postsecondary Education Subcommittee during the last Congress at a San Marcos, Texas hearing which you attended, former Congressman and leading educator John Brademas graphically described how higher education spending cutbacks during the past several years have escalated the campus cost crisis:

> "Particularly hard hit . . . have been student financial aid programs, guaranteed student loans, Pell grants among them. Support for all these programs has dropped from $10.8 billion in 1981, to just under $8 billion in 1984, *a decline in current dollars from over 25 percent*."*/

He further noted that adjusted for inflation, total student aid amounts are smaller than ever; and the costs of attendance at *all* types of higher education institutions have increased faster than the rate of inflation, while on average, family incomes have just about kept even. As a result, "college has become relatively more difficult for families to afford in the 1980s."**/

The Brademas statement echoed previous similar remarks by Texas Representative Wilhelmina Delco from Austin when she appeared before the same Subcommittee (to discuss the excessively heavy impact of these problems on minority students and institutions) at a hearing which you also attended. At that hearing, she identified the "most critical problem area that is facing higher education today" as "*the ever-soaring costs of education*" reflected by substantially increased tuition and fees, at a time when government higher education spending has been substantially reduced and reliance upon borrowing rather than grants is heavier than ever. */

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*/ Brademas Statement (Ex. 3) at 7.

**/ *Id.* at 9.

Unsuccessfully seeking solutions to the above, the Republican-controlled Senate Labor and Human Resources Committee noted last year that between 1980 and 1986, the average cost for a private college education *doubled*, tuition rose by *two-thirds*, the student population reflected a number of impoverished single parents returning to school and students were being forced to incur tremendous financial debt merely to meet basic educational costs.**/ In assessing the inadequacies of government solutions developed to deal with the problem, the House Committee on Education and Labor cited "erosion in the value of student aid generally, the disproportionate decline in the purchasing power of grant assistance and the dramatic increase in student borrowing. In constant dollars, *the value of student aid declined by 21 percent*" during most of the 1980s; and "while the value of *all* Federal student aid declined by one-fifth, the purchasing power of the *primary federal grant program* decreased by nearly *one-half*".***/Both Committees expressed concern that increased loans to an already debt-overburdened student population might well amplify these problems by further decreasing enrollment of otherwise qualified students. ****/

The recent *Newsweek* story enclosed here indicates that the higher education cost catastrophe cited above is becoming worse, not better.*****/ Regrettably, 1986 federal tax reform legislation which is otherwise commendable in so many ways may be exacerbating this result. Scholars studying the impact of last year's tax law changes on higher education have recently noted:

> "Tax reform has had a particularly unpleasant effect on students and their families. The cost of education will be increasing. The new restrictions on income shifting and other forms of tax-advantaged savings make saving for college more costly as well. Limiting deductibility of interest on student loans makes borrowing for tuition more expensive. And treating scholarships and fellowships as taxable income likewise increases the cost of attending the university."******/

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*/ Delco Statement (Ex. 4) at 103.

**/ Senate Labor and Human Resources Committee Report (Ex. 5) at 2.

***/ House Committee on Education and Labor Report (Ex. 6) at 6.

****/ *Id.* at 6.

*****/ Exhibit 7.

******/ ANDERSON & MEYERSON (Ex. 8) at 3.

In addition, last year's tax changes have made it more expensive for campuses to finance their facilities and equipment purchases while penalizing endowment donations by lowering the tax rates and thus making such donations more costly. */ Any Subcommittee UBIT analysis here cannot take place in isolation, and must necesesarily encompass the present bleak campus cost climate not likely to improve any time soon.

In studying the higher education cost situation, NACS has documented the student population's general financial inability to pay any increases. For example, in surveying student spending capabilities, NACS has learned that students obtain nearly one-half of all discretionary income used to finance costs other than tuition, room, board and textbooks from personal earnings gained through work study, summer and other employment; another 15 percent comes from government grants, loans and other government (GI Bill, ROTC, etc.) sources; and only one-third is available from parents or other relatives. **/ This discretionary income averages less than $100 per month. ***/ Given the very limited potential increase from the first two sources plus the relatively fixed parental income levels during the past several years, the student population would be unable to absorb higher costs attributable to UBIT changes through increased income sources even if non-discretionary educational costs (ostensibly less likely to be taxed in any UBIT change) were remaining fixed rather than rising so rapidly. Most students already consider college store textbook prices higher than they can afford, even though the markups are low by commercial standards. ****/ This undoubtedly explains why there are never any unfair competition complaints about textbook sales.

Based upon data compiled from the enclosed Student Watch Surveys last year, NACS observes with alarm that any change in present UBIT laws could render it even more difficult for the campus bookstore to meet student needs because of the adverse effects any such change would have on student costs. For example, most students already perceive campus bookstore prices as unreasonably high when compared to off-campus shopping alternatives.*/ In addition, most students consider product selection at the campus bookstores to be quite limited when compared to other retail outlets, and such selection would doubtlessly be even more limited if subjecting certain items to tax made them too costly to carry.**/ The Student Watch Surveys also indicate, however, that many students must continue to shop in the campus bookstores for convenience reasons.***/ This "captive" consumer class would merely be forced to pay the higher prices while sacrificing some other aspect of their generally meager student lifestyle.

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*/ Id.

**/ STUDENT WATCH, VOL. III (Ex. 9) at 149-150.

***/ Id., VOL I (Ex. 10) at 136-37.

****/ Id. at 39, 136. See also NACS LARGE STORE SURVEY showing 22-23% average markup (Ex. 14) at 13.

B. Subjection of Additional Campus Bookstore Revenues to Taxation Through Changing UBIT Laws Could Harm Store Ability To Benefit the Campus Community Without Providing Any Corresponding Benefit.

NACS accepts the need and even the desirability for maintaining federal UBIT laws. Consistent with current legal requirements, campuses report and pay UBIT on NACS college bookstore member activities as seen below. This suggests the adequacy of present law as applied to campus bookstores. NACS views with deep concern, however, any proposed changes in present UBIT laws which would expand the scope of taxable store transactions and thus increase store sale prices. In addition to harming the students for reasons already discussed, these increased prices can also impede campus bookstore ability to meet basic campus education needs.

It is important to note that the overwhelming portion of campus bookstore revenues comes from the sale of new textbooks at very thin (20-25 percent) margins.****/ The bookstores are reluctant to increase textbook prices (and on many campuses are prohibited from doing so) because of the adverse effects upon student costs. While recognizing that any change in UBIT laws would probably not attempt to tax textbooks, it is nonetheless important to note that subjection of other campus bookstore sales to tax would in most instances increase the prices of these items. This in turn could severely hamper the ability of college bookstores to continue utilizing revenue from the latter sales at higher mark-ups (29-40 percent) to subsidize the lowest possible textbook prices and keep them from rising.*/ Indeed, this cross-subsidization is not only commonplace but essential to most campus stores as well as other campus auxiliaries.**/ This is especially important at some campus bookstores, where textbooks are sold at even lower margins because of subsidies from higher margins on non-textbook items.***/ Such revenue is simply too important to jeopardize by taxing it, and to the extent any taxation resulted in reduced sales revenue for reasons of student inability to pay the higher prices, textbook prices would inevitably rise as well. In assessing whether to modify present UBIT laws, the Subcommittee should seek to avoid this latter result.

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*/ STUDENT WATCH, VOL. II (Ex. 11) at 173, 184, 265.

**/ *Id*. at 173, 265.

***/ *Id*.

****/ 1985-86 MERCHANDISING/OPERATING SURVEY (Ex. 12) at Table 3A.

Three further aspects of campus bookstore sales warrant mention. Campus bookstores, like other auxiliaries, generally show relatively modest surpluses from year to year. It is important to note that in most cases when such surpluses do result, however, the funds are plowed right back into educational and student financial aid programs as partial replacements for reduced government appropriations.****/ Second, it is also necessary to recall that many states require their campus auxiliaries to operate at a better than financial break-even level, regardless of whether meeting this mandate requires substantial service reductions. Any change in present UBIT laws likely to cause such reductions through increased auxiliary costs seems a result to be averted. Finally, it should be noted that unless the Subcommittee proposes to tax textbook and other basic educational sales by non-profit, tax-exempt campus bookstores through any change in UBIT law, subjection of other bookstore activities to taxation would appear to have minimal revenue-raising potential insufficient to offset the resulting adverse consequences for reasons illustrated below.

C. Evidence Indicates That College Bookstores Do Not Unfairly Compete With Private Businesses and the Former should Therefore Not Be Unfairly Penalized by Any Change in the Law.

A careful review of the enclosed documentation reveals no sound factual or evidentiary basis for concluding that college bookstores unfairly compete with private busineses. First, as already indicated, NACS off-campus private store members seldom if ever complain about any competition problems with their non-profit, tax-exempt counterparts on campus. Second, the recent NACS UBIT-Competition Survey indicates only an extremely small number of competition complaints (mainly involving computers and school supplies) against campus bookstore activities.*/ Third, as also already indicated, NACS Student Watch Survey results show that students perceive college bookstores as being too high-priced with too limited product selection in comparison with private sector shopping alternatives to pose any significant competitive risk. Moreover, this latter evidence also reveals that most students consider college bookstore parking such a serious problem that these bookstores attract few discretionary shoppers among consumers not already on campus attending classes.**/ In fact, the enclosed 1984-85 NACS Product Survey reveals only negligible purchasing volume from members of the general public; and further indicates that the larger stores draw even fewer shoppers from the public than smaller ones.***/

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*/ Id.

**/ COOPERS & LYBRAND STUDY (Ex. 15) at 23.

***/ 1985-86 MERCHANDISING/OPERATING SURVEY (Ex. 12) at Table 3A.

****/ COOPERS & LYBRAND STUDY (Ex. 15) at 22-23.

The NACS Student Watch shopping study offers a number of other interesting statistics which show few if any signs of campus store competitive activity. For example, although 96 percent of the students buy all their textbooks on campus, only 34 percent buy most of their other books and fewer than 20 percent buy most of their magazines there.****/ Moreover, NACS has found that more than half the students surveyed seldom if ever purchase any magazines, records, tapes, posters, clothing, video cassettes, film or other college "staple" items from the campus bookstores.*****/ In fact, despite the campus computer sale controversy, NACS has found that fewer than 10 percent of the students spend more than $50 per year on computer software in campus bookstores and two-thirds of all students seldom if ever buy any computer supplies there.******/ Perhaps the most revealing statistic of all, however, indicates that most students spend more money ($298) at department stores and private, off-campus bookstores each year than they spend at campus bookstores ($272), thus dispelling any campus bookstore competition notion once and for all.*******/ Despite the fact that campus bookstores are increasing the types of products they carry, these additional products are simply not selling in quantities sufficient to cause any competitive harm.[*]

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*/ Exhibit 1.

**/ STUDENT WATCH, VOL. II (Ex. 11) at 173.

***/ 1984-85 PRODUCT SURVEY (Ex. 13) at 120-21.

****/ STUDENT WATCH, VOL. II (Ex. 11) at 1.

*****/ Id. at 2, 279-281.

******/ Id. at 161, 280.

*******/ Id.

It is perhaps not unusual that campus bookstores have generated such little actual competitive threat. First of all, most campus bookstores offer limited personal service, and many are self-service.[**] Perhaps more significantly, the college bookstores spend between 0.1 percent (at community colleges) and 0.7 percent (at larger universities) of their budgets on advertising.[***] Only 17.4 percent of the campus bookstores even advertise the availability of rebates to their own students in the campus newspapers.[****] Finally, unlike private sector retailers, nearly three-fourths of the campus bookstores do not even run special promotional merchandise sales to reduce their inventories.[*****]

In viewing the operations of the stores themselves, it is easy to see why campus stores pose little if any competitive threat to the private sector. The 1985-86 Large Store Group Survey[******] analyzes the largest 85 U.S. (plus 4 Canadian) campus stores, ostensibly among the most likely to inflict such competitive harm. In the typical large store, however:

*Approximately one-half of the sales revenue comes from textbooks.[*******]

*Around 10 percent of all sales revenue comes from the sale of general books such as reference books and other recommended reading materials.[********]

*About 15 percent of all sales revenues comes from student supplies such as pencils, pens, notebooks, etc.[*********]

*About 10 percent of all sales revenues comes from school insignia items.[**********]

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[*] *See, e.g.*, 1984-85 PRODUCT SURVEY (Ex. 13).

[**] *Id.* at 315.

[***] *See* 1985-86 NACS MERCHANDISING/OPERATING SURVEY (Ex. 12) Tables 2A-2E advertising budget figures.

[****] STUDENT WATCH, VOL. II (Ex. 11) at 320.

[*****] *Id.*

[******] Ex. 14.

[*******] *Id.* at 13.

[********] *Id.* at 17.

[*********] *Id.* at 25.

[**********] *Id.* at 29.

> *The remainder of all sales revenues come from other items, most of which are food products, toiletries and other bona fide convenience items often not easily available off campus to a number of students.

Far from generating big surpluses, college bookstores have an average pre-tax net income before rebates to campus customers are factored in of under 4 percent, and 11 of the larger stores suffered/operating losses.*/ Even this modest "profit" percentage figure is misleadingly high, however, since most campus bookstores do not factor in depreciation costs because they are tax-exempt, non-profit entities.**/ The broader NACS 1985-86 Merchandising/Operating Survey,***/ which reviewed small, medium-size and community college campus bookstores in addition to the larger ones, reveals even greater reliance upon textbooks, general books, school supplies and essential educational items for all but the smallest percentage of bookstore revenues. These bookstores certainly seem to pose no competitive threat.

One additional comment regarding unfair competition deserves mention here. The Coopers & Lybrand Study and NACS UBIT-Competition Survey indicate that many of the unfair competition complaints made against all campus auxiliary or other activities involve the sale of discounted computers to students.****/ Indeed, some of these complaints may well be from members of the public barred from buying them at a discount because of manufacturer prohibitions. NACS suggests that far from constituting unfair competition, the sale of discounted computers only to students warrants Congressional commendation and should hardly be penalized by any adverse change in the tax laws.

D. **Campus Bookstores Already Report and Pay Taxes Where It Is Required, Thus Suggesting the Adequacy of Present Law as Applied to Their Activities.**

The NACS Large Store Survey is especially appropriate for use here, since it reveals that a number of the larger stores are reporting and paying taxes. For example, one store with the smallest percentage of textbook sales revenue and apparently the largest amount of income derived from contracting in-store services out to private vendors, paid $780,000 in federal taxes in 1986.*****/Nine other stores also report paying taxes. In fact, these 85 stores average 1.1 percent of their income as legally unrelated, and those with any unrelated income at all report only a 3.2-10.4 percent range.*/ Moreover, the Coopers & Lybrand Study shows that 20 percent of all campuses surveyed for all auxiliary activities paid UBIT.**/ These figures indicate that present UBIT law is working.

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*/ Id. at 53; 1985-86 MERCHANDISING/OPERATING SURVEY (Ex. 12) Table 3A net income figures.

**/ See COOPERS & LYBRAND STUDY (Ex. 15) at 39.

***/ Ex. 12.

****/ COOPERS & LYBRAND STUDY (Ex. 15) at 1, 23.

*****/ LARGE STORE SURVEY (Ex. 14) at 70-71.

E. Campus Bookstores Differ Substantially From One Another in Legal Form and Structure, and Any Change in UBIT laws Should Not Inadvertently Penalize Such Diversity.

The Coopers & Lybrand Study identifies six different types of legal structures applicable to campus stores, including:***/

*Stores operated as unincorporated divisions of the non-profit, tax-exempt campus.

*Cooperatives formed as non-profit, tax-exempt entities with the purpose of providing services to their members on a break-even basis.

*For-profit subsidiaries owned by the non-profit, tax-exempt campus parent.

*Non-profit subsidiaries owned by the non-profit, tax-exempt campus.

*Foundations, which generally serve as a non-profit, tax-exempt type of holding company or umbrella management structure over all campus auxiliaries in order to shift funds from one to another as needed to avoid aggregate financial losses on over-all auxiliary activities.

*Contract management or lease stores, whereby the campus contracts out store management to a for-profit, taxpaying business.

Most campus bookstores have traditionally utilized the first two categories, and the Study makes it clear that no single structure is superior to another since each campus benefits from its present freedom to choose which is most appropriate. In fact, state laws often dictate the type of structure to be used on public campuses.

These structural differences, characteristic of American higher education institutional diversity in general, nonetheless pose difficulties in developing federal legislative principles common to all. For example, because non-profit, tax-exempt bookstores do not operate on a profit-making basis, expense allocation in a tax accounting sense is exceptionally complex, especially since there is no site depreciation.*/ This in turn raises substantial doubt about the feasibility of attempting to develop new UBIT principles incapable of assessing each campus activity on its own particular educational merit for tax-exemption purposes. It would indeed be unfortunate if any UBIT law changes were to have the unintended effect of forcing campus auxiliaries into legal structures contrary to the best educational interests of the institution.

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*/ Id. at 57.

**/ COOPERS & LYBRAND STUDY (Ex. 15) at 2.

***/ Id. at 41.

F. UBIT Laws Should Remain Flexible Enough To Permit Each Individual Campus Situation To Determine the Taxable Consequences of Campus Educational Programs.

The recent UBIT hearings overlooked a key characteristic of the American higher education system, namely education program diversity. Such diversity makes it extremely difficult to apply certain uniform taxation principles to all campus educational activities without adverse economic consequences unless these principles are sufficiently flexible. Present UBIT law takes this into account and in fact reinforces the diversity characteristics of American higher education in general. For example, dance clothing sold in a campus store to students for use in off-campus leisure activities may be neither substantially related to nor necessarily serving the convenience of student education and could thus arguably be taxed under present law. When such clothing is utilized for a course or campus-sponsored extra curricular activities, however, it automatically acquires educational characteristics which easily warrant its tax exempt sale. The same analogy extends to potentially hundreds of other educational program-related products and services.

Taxation of any service or item used in bona fide campus educational activities which thus increases its cost because of any UBIT legal changes would appear to be unfair, and perhaps even unworkable. It is unfair to the student for selecting to participate in such activity; it is unfair to the campus bookstore for attempting to meet these legitimate needs; and it is unfair to the campus for guessing wrong in determining that a given activity in its own opinion is educational and thus tax exempt in nature. Often it is the states themselves which determine whether a given activity is educational in nature. To the extent that the federal government would attempt to second guess and then penalize decisions which have always been made in such a manner, this appears to be unnecessarily overreaching.

Present UBIT law works well as applied to the campus bookstore situation. It permits and even encourages IRS to audit store activities in each situation to determine whether a given product, service or activity is either substantially related to campus educational programs or serves the convenience of the campus community to make achievement of that mission possible. This result seems to be consistent with the intent of Congress in adopting the original UBIT law, and we question whether any change is more capable than present law in enabling both Congress and the higher educaton community to attain their mutual policy objectives.

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*/ Id. at 27-29. See also 1985-86 MERCHANDISING/OPERATING SURVEY (Ex. 12) at 38-39.

III. Concluding Comments

We appreciate the opportunity to provide you with the NACS views and enclosed documentation which show that present law works well as applied to the campus store situation. Unfair competition claims against the stores simply fail to withstand scrutiny when viewed in light of existing evidence; and such claims fail to justify any change in present laws. Clearly before any change is actually proposed, a very careful analysis of the economic impact likely to result from such change must be made. The plight of the student financial situation is all too well documented, and it is inconceivable that this Congress knowingly would adopt any legislative action likely to impose additional financial burdens on those who can least afford to shoulder them.

Please feel free to contact us if we can provide you with any further information or materials. Thank you again for your consideration of our concerns.

Sincerely,

Earl W. Kintner

Michael D. Barnes

Marc L. Fleischaker

David J. Aronofsky

Legal Counsel to the National
Association of College Stores

Enclosures
cc: Russlyn Guritz, Esquire
Vanessa Clark, Esquire

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

on

UNRELATED BUSINESS INCOME TAX

June 30, 1987

The National Association of Home Builders (NAHB), a trade association representing more than 147,000 members, is pleased to have this opportunity to submit a statement for the hearing before the House Ways and Means Subcommittee on Oversight. We respectfully request that this statement be included in the hearing record.

NAHB was formed in 1942 by a group of home builders who joined together to create an association that would unite the diverse members of the housing and building industry and serve the needs of the rapidly growing industry. NAHB since has evolved into a major trade association. The mission of NAHB is to enhance the climate for housing and the building industry and to promote and maintain policies that will keep housing a national priority. Chief among the Association's goals is providing and expanding opportunities for all consumers to have safe, decent and affordable housing.

NAHB is exempt from Federal income taxation, under Section 501(a) of the Internal Revenue Code, as an organization described in Code Section 501(c)(6). Section 501(c)(6) of the Code exempts from taxation business leagues, chambers of commerce, real estate boards, boards of trade or professional football leagues, not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual. In general, a business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit.

A trade association is the most common form of a business league. Typically, a trade association's membership consists of companies or persons engaged in the same line of business or operating within the same industry, and its purpose is to promote or improve the conditions of the business or industry.

The membership of NAHB is as diverse as the building industry itself. NAHB's members include small-, moderate-, and large-volume homebuilders, and multifamily and commercial builders and remodelers who are involved in all types of construction, including custom-built homes and townhouses, high-rise apartments and condominiums, office buildings and shopping centers, and schools, churches and commercial/industrial buildings.

The Subcommittee has asked for statistical data concerning the scope and nature of tax-exempt organizations' income-producing activities. For its 1986 Fiscal Year, NAHB's total income can be broken down as follows: 43.4% from membership dues, 42.4% from the Annual Convention, 1.9% from NAHB's various councils, 2.7% from book sales, 1.6% from interest, 1.1% from rentals and 6.9% from other revenue.

Every January, over 50,000 members attend NAHB's Annual Convention-Exposition, one of the largest conventions and expositions in the world. For over 41 years, this annual trade show has combined a wide variety of educational programs and workshops with an exhibition of building materials, tools and equipment. With over 340,000 square feet of exhibits, NAHB members who attend the convention can see and learn about the newest products displayed by leading manufacturers and firms. Over 170 separate educational programs are conducted at the annual convention. (An attachment to this statement lists the educational programs at our most recent convention.)

Over the years, NAHB has created a number of industry councils. These councils provide members who are already in specialized fields with educational, technical and business management programs to expand their knowledge and sharpen their skills. These councils also work to attract new members who could benefit from these services. Currently, NAHB has eight industry councils: The National Remodelers Council, The National Council of the Multifamily Housing Industry, The National Commercial Builders Council, The National Sales and Marketing Council, The Institute of Residential Marketing, The Building Systems Councils, The National Council of the Housing Industry and The Rural Housing Council.

Keeping its members apprised of events within the industry is one of NAHB's major tasks. In order to make the latest information on a variety of housing-related subjects available to members, NAHB designs, publishes, and sells a variety of items, including books, brochures, pamphlets and audio-visual materials.

Tax-exempt organizations generally are taxed on active business income that arises from activities that are unrelated to the organization's tax-exempt purposes. The major objective of the tax is to eliminate a source of unfair competition by placing unrelated business activities of tax-exempt organizations on the same tax basis as non-exempt business enterprises with which they compete. This tax structure, which has been part of the law since 1950, has generally been felt to be a more effective and workable sanction for enforcement of the law of tax-exempt organizations than outright denial of tax-exempt status.

An important exception to the unrelated business income tax is provided for trade shows and conventions. Under this exception, an unrelated trade or business does not include the qualified convention and trade show activities of an eligible organization (Code Sec.513(d)(1)). Qualified conventions and trade show activities are defined as any activity of a kind traditionally conducted at conventions, annual meetings or trade shows, including, but not limited to, any activity one of the purposes of which is to attract persons in an industry generally as well as members of the public to the show for the purpose of displaying industry products or services, or to educate persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry (Code Sec.513(d)(3)(A) and Treasury Regulation Sec.1.513-3(c)(4)).

For purposes of the exemption to unrelated business income tax, a qualified convention and trade show activity is a convention and trade show activity that is: (1) carried out by a qualifying organization; (2) conducted in conjunction with an international, national, state, regional or local convention, annual meeting or show; (3) sponsored by a qualifying organization that has as one of its purposes in sponsoring the activity, the promotion and stimulation of interest in and demand for the products and services of the industry involved in general or the education of persons in attendance regarding new developments or products and services related to the tax-exempt organization; and (4) designed to achieve this purpose through the character of the exhibits and the extent of the industry products displayed (Code Sec.513(3)(B)).

As indicated above, over 40% of NAHB's annual revenue is derived from its convention. Thus, in order for NAHB to continue to best serve its members and to fulfill its tax-exempt purposes; it is crucial that the exception for conventions be retained.

NAHB believes that the unrelated business income tax serves a valuable purpose. That is, trade or business activities that are regularly carried on by a tax-exempt organization should be taxed. Tax-exempt organizations that undertake those types of activities should not enjoy a competitive advantage over their counterparts that are fully taxable. In fact, should the business activities of a tax-exempt organization become such that it loses sight of the exempt purposes for which it was formed, it ought to be taxed as any regular business. However, as you examine these problems, we urge that you not become overzealous and impinge upon the traditional activities pursued by tax-exempt organizations in furtherance of their tax-exempt purposes and objectives.

Perhaps what is needed are more objective criteria concerning what constitutes a business activity that is regularly carried on. As you proceed with this task, NAHB would be pleased to assist you in any way possible.

Again, we appreciate the opportunity to submit this statement for the hearing record and look forward to working with the Subcommittee and its staff on this issue.

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July 17, 1987

COMMITTEE ON
[illegible]
WAYS AND MEANS

The Honorable J. J. Pickle
Chairman
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Attn: Robert J. Leonard, Chief Counsel

Dear Congressman Pickle:

The purpose of this correspondence is to transmit materials to be included in the published record of the Committee's recent hearings on unrelated business income tax.

As a member of the Steering Committee of the Business Coalition for Fair Competition (BCFC), our organization fully endorses the recommendations which the BCFC presented to the Oversight Subcommittee. Likewise, as a Board member of the Small Business Legislative Council (SBLC), we fully endorse the SBLC's recommendations submitted to the Subcommittee. Because of our long-standing involvement with these two organizations, we thought that it not be appropriate to request time before the Committee for an appearance. The materials that we submit, however, provide more exact information as to the nature of the nonprofit competitors which our members, as independent retail pharmacists, are confronting in their marketplace.

Once again, we are deeply appreciative of Congressman Pickle's support of H.R. 1207, the drug diversion legislation, which passed the House in early May and will soon be reported from the Finance Committee and presented to the Senate. This legislation goes a long way towards addressing the unique circumstances involved with our nonprofit/non-taxpaying competitors in that it will deny their use of products ostensibly obtained because of their charitable activities in the retail marketplace. It certainly does not address the wide range of special advantages utilized by our nonprofit competitors but is a major first step.

On behalf of the owners of 30,000 independent pharmacies, where 75,000 pharmacists dispense approximately 70 percent of all prescriptions and serve 18 million consumers daily, we appreciate the opportunity to assist the Subcommittee in its investigation.

With warm regards,

John M Rector

John M. Rector, Esq.
General Counsel & Vice President
Government Affairs

JMR/mbs
Enclosures

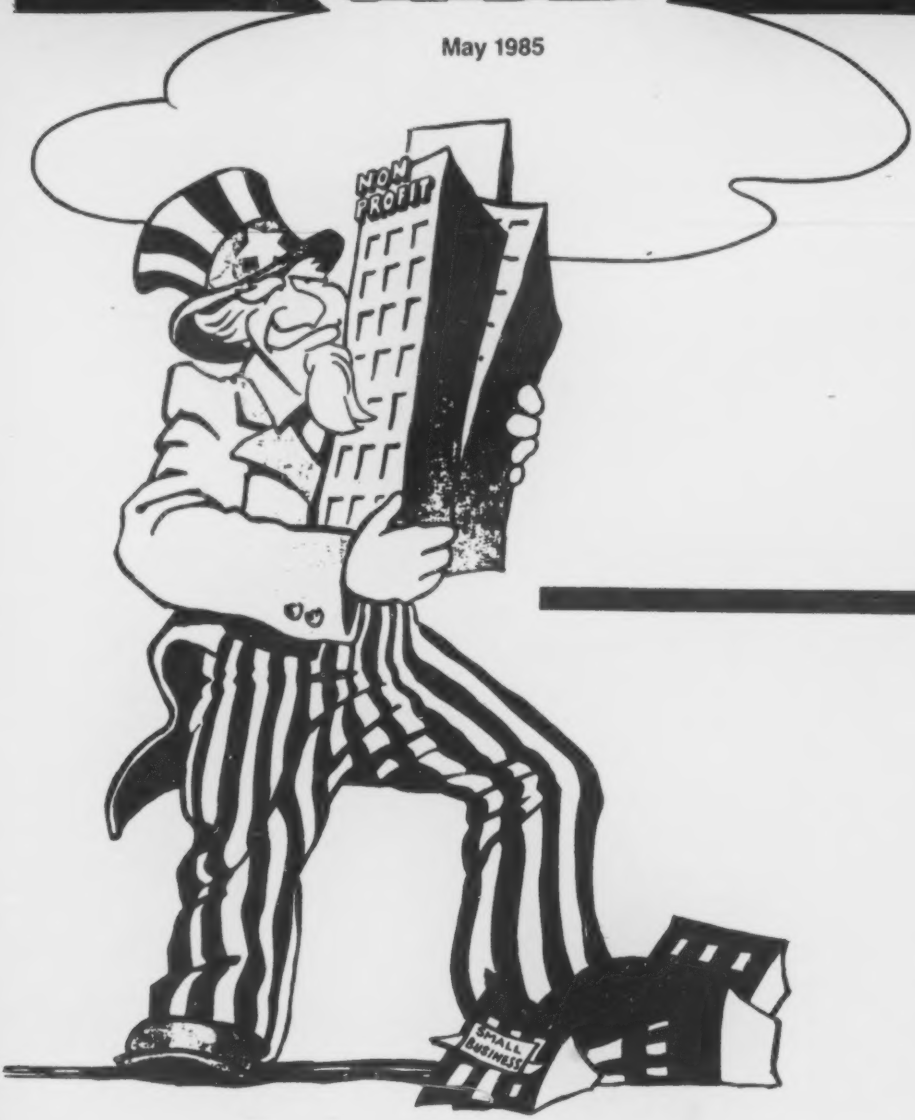
National Association of Retail Druggists
Voice of the Independent Pharmacist

NARD

Turf Wars in Alabama

Diuretic Agents: A Review

May 1985


NON PROFIT
SMALL BUSINESS

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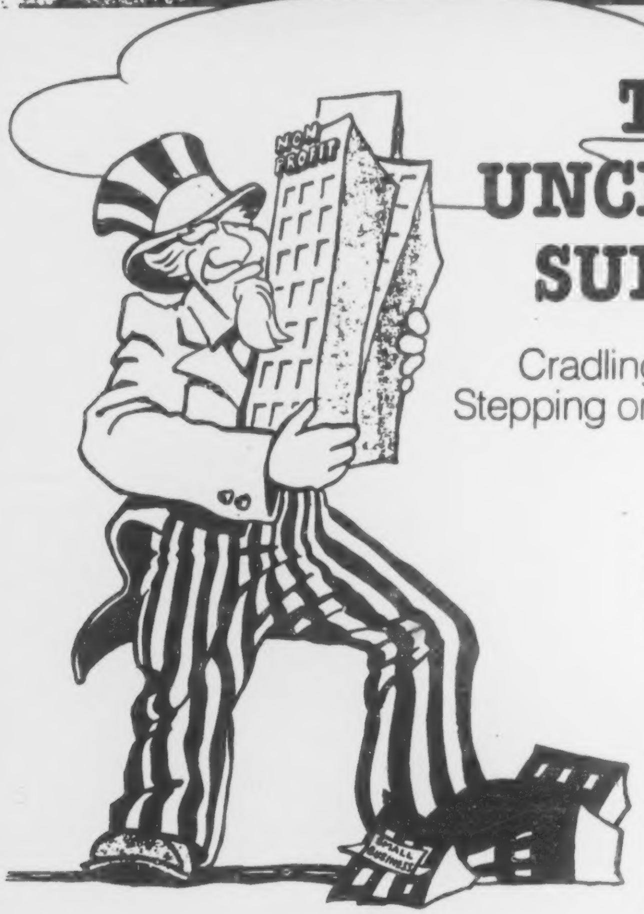


THE UNCLE SAM SUBSIDY

Cradling Nonprofits, Stepping on Small Business

'Nonprofits are a whole can of worms that Congress has yet to look at in a broad way. I have been blowing the trumpet for years to get lawmakers to spell out clearly what should be tax-exempt and what should not be.'

—Sheldon Cohen, former Commissioner of the Internal Revenue Service

When Cohen raised his Gabriel's horn seven years ago, few were listening. But today there is a clarion call at work in the nation: The time has come to re-examine nonprofit organizations and whether they exist for their primary stated purpose, or whether they are engaged in commercial enterprises while paying little or no tax and enjoying other preferential benefits under the shield of existing law.

This re-examination is occurring

both within the executive branch and on Capitol Hill, spurred on by a firestorm of criticism from the private sector, most notably small business. "Unfair competition" is the clarion call, and for once the feds seem to be listening.

'Unfair competition' is the clarion call, and for once the feds seem to be listening

The Office of Advocacy of the Small Business Administration supports change at both the legislative and regulatory level for tax-exempt nonprofit organizations that engage in commercial activities in competition with for-profit small firms that pay federal, state, and local taxes for the privilege of doing business. The problem was addressed at a recent Office of Advocacy symposium, and a subsequent report on the subject proved to be a popular item—more than 6,000 copies have been circulated. The report is not the usual summary of findings, but instead raises important public policy questions the SBA says "must be resolved."

The SBA also notes that the issue of "commercial nonprofits" operating in competition with small business is part of the much larger problem of government competition with the private sector. The agency echoed NARD's assertion that subsidizing nonprofit organizations through tax exemptions is a form of indirect government competition, *in addition to* direct competition where the government supplies to itself and to the public goods and services available from the private sector.

Independent retail pharmacists are no strangers to unfair competition. A recent appeals court decision allowing an HMO to purchase and sell drugs at discriminatorily low prices on the grounds that it is a nonprofit organization merely highlights the misuse of laws affording protection to a nonprofit enterprise. NARD long ago raised the issue of unfair competition from nonprofits in Congress, before both the Republican and Democratic Platform Committees, and in other forums.

Nonprofit organizations have experienced explosive growth in the past two decades. According to the IRS, more than 780,000 nonprofit entities were in existence in 1983, representing 3.5 percent of the Gross National Product and a volunteer labor pool estimated to represent 3 million full time workers.

The character of the nonprofit organization has also changed from the traditional "donative" groups, such as United Way, relying primarily on gifts and contributions to the so-called "commercial" nonprofits relying almost exclusively on sales income of the goods or services they produce. The accompanying table demonstrates that non-

Nonprofit organizations have enjoyed an explosive growth in the past two decades

In Search of UBI

Unrelated business income (UBI) activity on the part of nonprofit organizations has been a murky area for years. The UBI is imposed on the "gross income" of a nonprofit from an "unrelated trade or business" that is "regularly carried on" by the organization. Left to arcane interpretations, UBI has not been a fertile field for IRS enforcement activity—until recently.

According to a tax expert with a large Washington, DC accounting firm whose clients include major nonprofit organizations, IRS has been stepping up its audits of nontaxable tax returns and 990-Ts (forms for reporting UBI). "When the auditor is at the door," says the tax expert, "he generally is wearing a UBI hat. The field has laid dormant far too long because the operative rules are cumbersome and nasty to interpret."

How cumbersome the rules are is amply demonstrated by the SBA Office of Advocacy in its report on government competition. In a Texas case a nonprofit hospital operated an in-house pharmacy where sales of pharmaceuticals were made not only to hospital patients, but also to private patients of doctors on the hospital staff and to the general public. The court held that sales to private patients of the staff doctors were tax-exempt, but that sales to the general public were taxable. Its rationale was that the hospital needed doctors, and having a convenient pharmacy for the doctors' patients made it easier to keep doctors on staff, thus helping the hospital perform its tax-exempt function.

IRS, which is known for its quixotic rulings, determined that in a case involving a nonprofit zoo, sales of jewelry with animal motifs were taxable as UBI, but sales of stuffed toys in the shape of animals were tax-exempt. While UBI is clearly subject to interpretation, says one tax expert, when IRS launches an audit of a nonprofit, the agency is looking carefully at the "primary purpose of the organization; what is the organization doing now versus what it said it would do when it first applied for tax-exempt status. We've seen some examples where the 501 status gets yanked."

TABLE

Financing Sources of Nonprofits

(as % of total revenues)*

Area of Activity	Sales	Gifts, Contributions and Grants
Health Care Delivery	92%	8%
Scientific Research	86	14
Housing	61	39
Education	82	18
Mutual Organizations	99	1
Legal Aid	3	97

*Source: *Unfair Competition by Nonprofit Organizations with Small Business.* Office of Advocacy, U.S. Small Business Administration.

profits in health care delivery rely almost solely on sales for their operating revenues.

Nonprofit organizations receive special treatment under virtually every form of federal legislation affecting them. Especially prized is the exemption from federal corporate income tax under Section 501 of the Internal Revenue Code. Other special treatment or exemption include unemployment insurance, minimum wage, securities regulations, bankruptcy, antitrust, unfair competition, copyright, and postal rates.

Section 501 grants tax exemption to 23 different categories of organizations, the most common of which fall under 501(c)(3)—charitable, religious, scientific, and educational institutions. More than 39 percent (306,000) of all nonprofit tax-exempt groups fall into this category. The Internal Revenue Code requires these groups "to be organized and operated exclusively" for a primary purpose. They are not prohibited from engaging in commercial activities provided those activities are directed to the organizations' tax-exempt purposes. Congress attempted to tax such commercial ventures with an "unrelated business income" tax, or UBI, in 1950, indicating through legislative intent that the tax was aimed at unfair competition with for-profit firms.

The 1938 Nonprofit Institutions Act was intended to exempt 'truly charitable' organizations from Robinson-Patman provisions

The test for UBI falls into a vast gray area of interpretation and IRS, until recently, has paid little enforcement attention to nonprofits. Total fiscal year 1982 collections by the agency were only $24.6 million.

Another shield for nonprofit business activity is the Nonprofit Institutions Act of 1938. This act was intended to exempt from Robinson-Patman antitrust provisions "charitable institutions not operated for profit," such as the "alms houses" and "paupers hospitals" that existed when the law was passed in 1938. In *Kaiser v. PRDA* the Kaiser Foundation Health Plan (HP) was found to be a "charitable institution" and, thus, covered under the 1938 act. The appellate court ruled that because "the HPs and Kaiser Hospitals must fulfill their need for certain medical services by contracting with doctors who seek a profit does not make the HPs and Kaiser Hospitals themselves for-profit organizations."

The marketplace activity that many nonprofits are engaged in today places them in the commercial nonprofit category. Organizations such as nonprofit hospitals, day care centers, nursing homes, research institutes, and publications houses receive few donations and charge prices for the goods or services that they produce. More important, because of their preferential treatment, including tax breaks, these commercial nonprofits compete unfairly in a variety of industries with for-profit firms.

Where the competition is

Independent retail pharmacy has experienced unfair competition from a variety of nonprofits as well as government sources. Nonprofit hospitals and nonprofit health maintenance organizations (such as Kaiser) are two entities that pose increasing threats to an open marketplace.

In a recent *Washington Post* article on "Medicine Inc.: Big Business at the Bedside," Kaiser was said to have already covered 18 percent of the population of California. The giant HMO is now in the Washington, DC area, Raleigh-Durham, NC, and Westchester County in New York. It will open soon in Charlotte, NC and Atlanta, GA, and may soon take over the big Health Insurance Plan of Greater New York, one of the oldest HMOs, the article asserts. For a "charitable" nonprofit institution, Kaiser clearly represents a commercial nonprofit enterprise.

The traditional rationales for exempting nonprofits from income taxation do not withstand close scrutiny

But there are many other industries where commercial nonprofits are providing stiff competition with for-profit firms. SBA notes the following:

- The travel agency industry, composed almost entirely of small business firms, is experiencing competition from nonprofits in the form of on-campus travel centers operated by colleges and universities, all of whom provide lower cost travel made possible by reduced postal rates, tax exemptions, and the use of volunteer labor.

- The hearing aid industry, once made up almost exclusively of proprietary firms, has seen an incursion by nonprofit hospitals and clinics at the retail end. One Washington state hospital with an affiliated hearing aid center incurred an annual average loss of $15,000 in the early 1970s with its pathology diagnostic services until it moved into hearing aid sales. By 1979 the center grossed in excess of $1 million annually with profits of over $150,000.
- Three nonprofit hospitals located in Philadelphia established prosthesis manufacturing shops in direct competition with local artificial-limb manufacturers that previously supplied the bulk of the hospitals' needs.
- A New Jersey nonprofit hospital began marketing its laundry services to other hospitals in its area at one cent per pound less than the lowest commercial rate available from local private laundry services.
- The University of Michigan negotiated an arrangement with a leading computer manufacturer for the purchase of $2 million of its computers for academic use as well as for resale to students and faculty. The computers, already purchased at discount rates, were offered to students and faculty for their own individual use at slightly over half the normal retail price for such items. Local computer retailers reported a 50 percent drop in sales of this particular computer as a result of this arrangement. Some dealers are expected to go out of business altogether.

SBA reports that many industries are involved in commercial nonprofit competition, ranging from computer services to research services to analytical testing, among others cited in its findings.

The Office of Advocacy concludes that, "The traditional rationales for exempting nonprofits from federal income taxation do not withstand close scrutiny, particularly as applied to the modern-day commercial nonprofits that offer goods and services in direct competition with for-profit firms. It is time for a critical reappraisal of the principles that supposedly justify the special tax treatment that nonprofits receive."

Proposed remedies

SBA's chief counsel for advocacy, Frank Swain, proposes incremental changes in federal laws which would discourage nonprofits from engaging in for-profit business activities, including the following:

- Since a nonprofit's unrelated business income is taxed at ordinary corporate income tax rates, Congress could increase the tax by taxing the first dollar of UBI at the highest marginal corporate tax rate rather than the lowest. A more significant change would be to prohibit unrelated business activities outright.
- IRS should focus not only on the extent to which the business activities relate to the nonprofit's exempt purpose, but also look at the extent to which the activities affect commercial firms, in keeping with Congress' original intent when it strove to prevent unfair competition by imposing the UBI tax.
- IRS should promulgate a regulation that if a section 501(c)(3)

Nonprofit Third-Class Mail Bonanza

If you use direct mail to promote your pharmacy services, you know that each flyer sent to a prospective customer will cost you 12.5 cents apiece under current third-class bulk rates for commercial postal users. But if you are a nonprofit organization—such as the American Association for Retired Persons—the rate drops to six cents apiece because of preferential treatment accorded "qualified nonprofit organizations"—U.S. Post Office lingo for a host of religious, educational, scientific, and philanthropic groups, some of which are traditional, some commercial. Are such price differentials fair, especially when groups like AARP are also in the mail order prescription drug business in competition with private sector pharmacy providers?

The magnitude of such subsidies break for qualified nonprofit organizations is a matter of public record. So substantial are the benefits that the Reagan Administration has proposed in its fiscal 1986 budget that the "revenue forgone" appropriations for various nonprofits be curtailed. The term "revenue foregone" was set in congressional policy decades ago. Preferred mailers are not charged the regular postal rates most mailers are charged because the Postal Service "forgoes" collection of the full rate. If Congress does not provide forgone revenue by means of an annual appropriation, then the Postal Service is empowered by law to raise the preferred rates to the "level necessary to make up the difference—all the way up to the full commercial rate."

For nonprofit organizations a no-revenue-forgone appropriation would mean an approximate 144.1 percent increase in the cost of mailing a third-class fund raising letter. According to the Congressional Record, the American Association of Retired Persons would have an annual postage increase with no subsidy of $6.5 million.

The administration's proposal has already been adopted by the Senate Budget Committee.

nonprofit engages in a specified amount of business activities (as a percent of total operating revenues), it will be *presumed* to be operating for other than tax-exempt purposes.

- The Federal Trade Commission Act should be amended to clarify the inclusion of nonprofit entities under FTC scrutiny for engaging in unfair or anticompetitive trade practices. Apologists for commercial nonprofits claim that the act includes only for-profit entities or trade associations representing for-profit firms.

Unfair competition with commercial nonprofits is a top priority with NARD. Early this year in testimony before the Senate Small Business Committee, NARD targeted the Nonprofit Institutions Act as a law sorely in need of modification. The association is also pursuing amendment to the Federal HMO Act through the House Health Subcommittee, chaired by Rep. Henry Waxman (D-CA).

The fight to secure equity for the commercial private sector may not be unlike the prolonged struggle to secure pharmacy crime legislation. But the cause is earning some powerful allies at the outset with the SBA champing at the bit to lead the charge. ■

West Urges Industry/Pharmacy Alliance Against Discriminatory Pricing

NARD Executive Vice President Charles West took the association's legislative campaign against government competition with the private sector to the annual meeting of the Pharmaceutical Manufacturers Association in Boca Raton, FL in April.

Participating in a first-ever PMA panel discussion on pharmacy issues, West called on the drug industry to join with NARD on Capitol Hill in the fight against government-supported discriminatory pricing in the pharmaceutical marketplace.

Price disparities

Noting that the Supreme Court has already ruled in the landmark *Jefferson County* decision that direct government competition is not exempt from the antitrust laws, West devoted the bulk of his PMA remarks to the more insidious indirect forms of competition created and subsidized by government. That kind of government-supported competition "exists in the form of tax breaks, postal subsidies, and other advantages originally enacted for charities," said NARD's chief executive, "but used today by so-called 'nonprofit' institutions that compete with commercial enterprises."

"The price disparity that commercial nonprofits enjoy can be astounding," West told the audience of top industry decision makers. "Discounts of 90 percent and more off AWP are not uncommon," he said, emphasizing that no retailer receives volume discounts anywhere near that high. "These organizations can sell Rx drugs cheaper than pharmacists can buy them, and still make huge profits," said West.

> ***'Pharmacy organizations and the pharmaceutical manufacturers can petition Congress to eliminate the source of such discriminatory prices'***

"For consumers, the price of this government intrusion is high," he continued. "Taxpayers not only subsidize these organizations, they pay higher prices because of them. For example, pharmaceutical manufacturers, forced by competitive pressures to provide drugs to nonprofits at extraordinarily low prices, end up shifting those manufacturing costs to the paying public. Consumers pay twice—first in taxes to subsidize commercial nonprofits, then again in increased drug prices resulting from cost shifting by manufacturers."

West cited the counterfeiting of Rx drugs marketed by PMA firms as one example of the illegal conduct spawned by discriminatory pricing. But also "illustrative of such bold and blatantly illegal efforts," said West, "are 'brokers' touting programs in which nonprofit hospitals are requested to increase their pharmaceutical purchase orders under special hospital prices and then ship them to the broker. The broker agrees to pay the hospital a percentage of the purchase price plus other methods of compensation. The hospital is warned not to increase its purchases too dramatically so as not to alert you, the manufacturer, to the diversion."

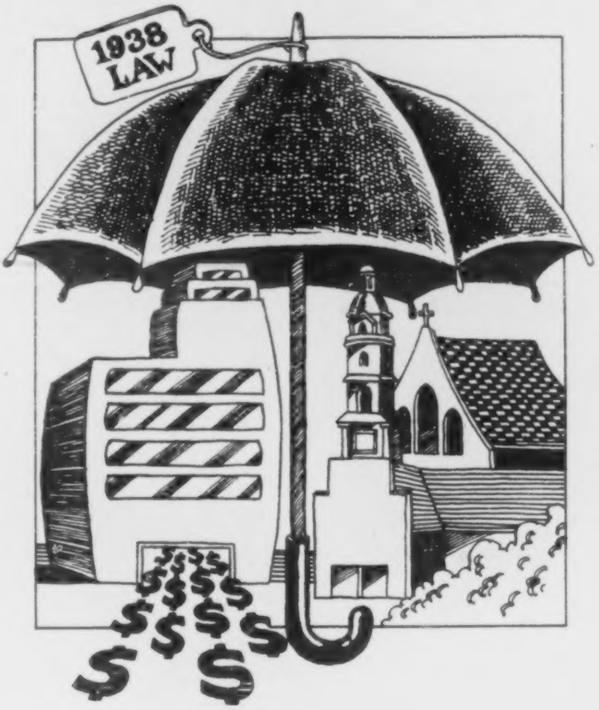
NARD is exploring a variety of legislative options to curtail the unfair government interference in the private sector that creates these types of abuses, including changes in the tax code, the HMO Act, the FTC Act, and the 1938 Nonprofit Institutions Act. "Many in Congress are expressing an interest in developing appropriate solutions," West told the manufacturers at the meeting.

West concluded his remarks with an invitation to the drug industry. "We invite you to join our campaign," said West. "Pharmacy organizations and the pharmaceutical manufacturers can petition Congress to eliminate the source of such discriminatory prices. Pharmacy, industry, and the public will all be winners."

> ***'These organizations can sell Rx drugs cheaper than pharmacists can buy them, and still make huge profits'***

The Case for Amending the Nonprofit Institutions Act

Puncturing the "Charitable" Umbrella for Commercial Enterprises



For years NARD has staunchly fought government competition with the private sector. In some cases, including the landmark Jefferson County v. Abbott decision, government interference was manifested as *direct* competition with private, tax-paying enterprises.

But equally threatening are the many forms of *indirect* competition created and subsidized by government. Most commonly, indirect competition exists in the form of tax breaks, postal subsidies, and other advantages originally enacted for charities, but used today by so-called "nonprofit" institutions that compete with commercial enterprises.

In 1984 NARD's House of Delegates unanimously adopted a position that "no small business should tolerate a government allocation of their taxes for projects that unfairly compete with the very sources of the tax revenue: business generated by enterprising independent retail pharmacists." That reiterated the Association's statement of the previous year calling for "vigorous enforcement and oversight of price discrimination laws by both the Federal Trade Commission and the Department of Justice."

NARD is exploring a variety of legislative options to curtail this unfair government interference, including changes in the tax code, the HMO Act, the FTC Act, and the 1938 Nonprofit Institutions Act.

'Nonprofit'

In a broad sense, granting "nonprofit" entities—hospitals, HMOs, and organizations that have the potential to draw patrons away from commercial organizations—tax breaks, postal concessions, or other benefits not afforded commercial institutions are all forms of government competition. Clearly, there are organizations that, in the public interest, deserve some relief from taxation and other government intrusions. But when the government extends nonprofit relief to organizations operating in whole or in part in the private sector, the relief becomes an unfair competitive advantage and an example of unnecessary government interference in the free market.

Even direct government competition such as government clinics or other services, long thought to be totally exempt from antitrust laws, have been held to be subject to provisions of the Robinson-Patman Act prohibiting price discrimination. In the landmark *Jefferson County* decision, the Supreme Court ruled that a state-run hospital could not establish a retail pharmacy providing drugs in competition with the private sector.

Cost shifting

But indirect government competition is less visible, and far more widespread. For consumers, the price of this government intrusion in the free market is high. Taxpayers not only subsidize these organizations, they pay higher prices because of them. For example, pharmaceutical manufacturers, forced by competitive pressures to provide drugs to nonprofits at extraordinarily low prices, end up shifting those manufacturing costs to the paying public. Consumers pay twice—first in taxes to subsidize commercial nonprofits, then again in increased drug prices due to cost-shifting by manufacturers.

The discriminatory prices offered to these commercial nonprofits are not based on volume purchasing or frugal business practices, and are not available to other commercial enterprises.

The manufacturers insist that their competitors leave them no choice but to provide drugs to nonprofit organizations at discriminatorily low prices. "If we don't do it, somebody else will," or, "If we stop, they won't," are the familiar refrains—and the government allows the practice to continue.

> **Among the most harmful anticompetitive practices is the purchase and sale of pharmacy products at discriminatory prices**

Retail pharmacists, especially independents, are pharmaceutical manufacturers' best customers. But they take it on the chin from the paying public for drug price increases. It's no wonder pharmacists must increasingly look to alternative buying opportunities such as co-ops, generics, and others.

The price disparity commercial nonprofits enjoy can be astounding. Discounts of 90 percent and more off AWP are common. These organizations can *sell* Rx drugs cheaper than pharmacists can *buy* them.

Now independent retail pharmacy and pharmaceutical manufacturers have an issue both can fight for that would do away with the manufacturers' problem and return fair competition to the retail marketplace: repeal or modification of the Nonprofit Institutions Act. But for this law, commercial organizations that buy and sell drugs at discriminatory prices under the "nonprofit" mask would be criminally liable under Robinson-Patman. The Nonprofit Institutions Act, passed in 1938, was designed to exempt "truly charitable" institutions such as "paupers hospitals" and "alms houses" from provisions of the then two-year-old Robinson-Patman Act, which prohibits price discrimination.

Recent focus

The recent decision in the ninth circuit, in which an appeals court upheld an argument by the Kaiser Foundation Health Plan that its HMO was exempt from Robinson-Patman under the Nonprofit Institutions Act, focused attention on the need to correct the law.

Fortunately, the decision in the ninth circuit is not a national trend, and applies only to the states within that circuit. The other 46 states still fall under the Supreme Court decision in *Portland Retail Druggists Association v. Abbott Laboratories, et. al.*, in which the Court through the "own use" test held such conduct to be non-exempt. But the existence of a law that is being used for purposes far removed from its original intent remains a problem. If the Supreme Court had ruled on the ninth circuit decision, using the same philosophy as it did in Jefferson County, the decision would have been overturned.

Strict exemptions

NARD's view is that Congress has not exempted health maintenance organizations or other business entities from the Robinson-Patman Act, and that the Supreme Court, in *PRDA v. Abbott*, had ruled that "the antitrust laws, and Robinson-Patman in particular, are to be construed liberally, and . . . exceptions from their application are to be construed strictly."

> **Manufacturers explain their nonprofit price policies as a response to competitive pressures**

NARD further holds that a broad exemption from antitrust law like that used in the ninth circuit is a misinterpretation of 1938 nonprofit act. Using an IRS tax law definition of "charitable" to apply the Nonprofit Institutions Act exemption to

(continued on page 52)

NARD in Portland: Government Competition

NARD Government Affairs Director John Rector brought the issue of government competition through subsidies to the private sector to the Fred Grill Memorial Discussions, held March 3 in Portland, OR. Rector reviewed the status of many legislative issues, including NARD's pharmacist-legend initiative, HCFA Region VI actions to remove pharmacists' earned discounts, the controversy over the application of Employee Retirement Income Security Act provisions to drug reimbursement policies in the states, legislation to legalize heroin, and the effect of the DRG freeze on nonprofit hospitals.

NARD's John Rector

But the primary issue the pharmacists from the Portland area wanted to discuss was government competition, including the limits of the recent Ninth Circuit Court decision, NARD's proposed repeal or modification of the Nonprofit Institutions Act, and the possibility of expanding the "lower-of" provision presently applied only to pharmacy sales to include manufacturers' sales as well.

Rector encouraged the development of coalitions to lobby government effectively, as well as the use of PAC resources. He noted that the key to using a political action committee is "doing well with what you have."

"Politicians will always be there when they need you," said Rector. "Working together, our job is to make sure they *always* need you."

(continued from page 42)

the HMO makes no sense. The nonprofit institutions exemption is intended for organizations that *do not compete* with other purchasers. The tax laws are designed to serve a totally different rationale that is not applicable to antitrust.

Finally, NARD notes that the Nonprofit Institutions Act exemption is being misused when courts find that drugs are purchased by HMOs "for their own use"—a restriction incorporated in the nonprofit institutions exemption. Congress has specifically rejected bills that would make drug benefits a required service of HMOs because it did not want to create favored channels of retail distribution. Misuse of the Nonprofit Institutions Act to allow HMOs or similar commerical organizations to purchase and distribute drugs to patients at extraordinarily low prices clearly creates a favored channel of retail distribution, in conflict with the intent of Congress and contrary to the provisions of Robinson-Patman.

> **'The antitrust laws are to be construed liberally, exceptions are to be construed strictly'**

Window of opportunity

The Nonprofit Institutions Act should not apply to commercial activities. The idea that a health maintenance organization is a non-commercial institution that does not compete with other retail pharmacies is ludicrous. But so long as the Nonprofit Institutions Act is allowed to be interpreted broadly, the opportunity remains for competing organizations to duck the antitrust laws.

NARD is committed to repeal or modification of the law—to make possible single pricing structure for commercial providers and put in place a more accurate definition of "charitable" as it pertains to the 1938 act.

Now pharmaceutical manufacturers, NARD, and other pharmacy organizations can petition Congress to do away with the source of the problem, armed with a new example of misuse and misinterpretation of the law. Pharmacy, industry, and the public will all be winners.

COMMITTEE ON NATIONAL LEGISLATION AND GOVERNMENT AFFAIRS

Subject: ***Government Competition***

Discussion: The elimination of unfair competition with independent pharmacies should be an essential component of the NARD agenda for the 99th Congress and beyond. Especially obnoxious is unfair government competition. It is NARD's position that no small business should tolerate a government allocation of their taxes for projects that unfairly compete with the very sources of the tax revenue: business generated by enterprising independent retail pharmacists.

The Veterans Administration's mail order prescription drug program, which denies veterans the freedom to choose a convenient retail pharmacy to provide their pharmaceutical services and products, is a glaring example of such government competition. NARD should continue its work toward enactment of H.R. 608, introduced by Hammerschmidt (R-AR) at NARD's request, which would provide freedom of choice to veterans to obtain their pharmaceutical products and services in the marketplace.

Consumer freedom of choice for pharmaceutical services should be incorporated into all federally funded programs providing these services—for example, HMOs, family planning, home health care, venereal disease, and mental health clinics.

NARD should, as it did earlier this year, encourage the enforcement of the *Jefferson Co. vs. Abbott* decision, which held that government was not exempt from the antitrust laws when it entered the marketplace to compete with independent retail pharmacies.

Government hospitals and clinics, including pharmacy school outpatient clinics selling at unfair prices because of institutional purchasing, should be a particular target of NARD's effort to eliminate government competition with NARD members.

NARD should take all steps feasible to maximize the participation by pharmacy in the White House Small Business Conference established by Congress in PL 98-276. NARD should be commended for providing the leadership for the profession through the establishment in May of its Small Business Issues Clearinghouse to help assure input to the White House in the planning and development of the Conference.

Recommendation: That NARD continue to build on past successes aimed at reducing government competition with independent retail pharmacists.

UNANIMOUSLY APPROVED AT THE NARD 86TH ANNUAL CONVENTION AND TRADE EXPOSITION, OCTOBER 1-4, 1984, MIAMI BEACH, FLORIDA.

(OVER)

Subject: ***Pharmacy and Antitrust***

Discussion: Nowhere is NARD's foresight and leadership more evident than its long-time campaign for antitrust relief that would permit independent pharmacists to bargain as peers in the development and implementation of third-party prescription programs. NARD has worked with its friends in Congress for years to achieve this goal, while other pharmacy organizations rebuked the NARD campaign, calling it a "quick fix." As was the case with the pharmacy crime law, progress has been made each year since Congress, at NARD's request, held the so-called Hungate hearings in 1971.

In the 99th Congress, legislation introduced for NARD, this time H.R. 752, should be a top priority.

Current antitrust laws prevent pharmacists as a group from negotiating the reimbursement for a third-party prescription. Independent pharmacists do not want a handout, just an opportunity to compete and earn a fair profit for their services and products.

The legislation would establish a limited exemption from the antitrust laws to permit community pharmacists to collectively negotiate with third party program administrators and sponsors.

NARD should continue its support for the Fair Competition Act of 1984, H.R. 5237. It is designed to clarify provisions of the antitrust laws that have long prohibited predatory pricing practices, but have lacked clear and enforceable guidelines to identify illegal and anticompetitive predation. Independent retail pharmacists, as well as the industry as a whole, will benefit from a clearer standard of fair competition.

NARD should carefully monitor the Preferred Provider Health Care Acts, introduced in both Houses of Congress, to help assure that independent retail pharmacy be provided equal opportunity to participate in any new form of health care delivery.

NARD should continue to call for the vigorous enforcement of price discrimination laws and other antitrust laws by both the Federal Trade Commission and the Department of Justice. It should also continue its careful monitoring of the Reagan administration's policy and programs on vertical restraints such as resale price maintenance, which have significant implications for independent retail pharmacy, including the reestablishment of fair trade laws.

The compliance by private nonprofit hospitals with the Supreme Court's decision in *Abbott v. The Portland Retail Druggists* should be a special concern of NARD. This effort should include a review of the advisability of repealing the "charitable" exemption to the Robinson-Patman Price Discrimination Act for "nonprofit" institutions that are no longer truly charitable as was originally the case when the exemption was enacted in the late 1930s.

Likewise, NARD should continue its efforts to prevent regulatory and legislative endeavors that would restrict the availability of pharmaceutical products to certain outlets. Special concerns include physician ownership of pharmacies, ownership of retail outlets by manufacturers, and restriction of veterinarian drugs. NARD should request that a hearing be held by the appropriate governmental agency or Congress to consider the exemption of retail outlets from the Robinson-Patman Act so those outlets can purchase drugs at the same costs presently extended to governmental agencies when dispensing medications covered by governmental programs.

Recommendation: That NARD continue to work to obtain exemption to the antitrust laws to permit pharmacists to negotiate, as a group, with third-party prescription program administrators; to obtain enforcement of existing laws against illegal hospital sales, especially by private nonprofit hospitals; to strengthen laws against predatory practices; and to provide independent pharmacists access to PPOs and other alternative health care delivery systems.

EXCERPT ON NONPROFIT COMPETITORS FROM THE

STATEMENT OF JOHN M. RECTOR

BEFORE THE HOUSE ENERGY AND COMMERCE

SUBCOMMITTEE ON TRANSPORTATION, TOURISM, AND HAZARDOUS MATERIALS

MAY 27, 1987

Mr. Chairman, Members of the Subcommittee*:

I am John M. Rector. I serve as General Counsel and Vice President of Government Affairs for the National Association of Retail Druggists.

The National Association of Retail Druggists represents the owners of nearly 30,000 independent pharmacies, where more than 75,000 pharmacists dispense 70 percent of the nation's prescription drugs. Together, they serve 18 million persons daily and provide 82 percent of Medicaid pharmaceutical services. Over 60 percent of NARD's members provide home health care pharmacy services. NARD has long been acknowledged as the sole advocate for the proprietary and professional interests of this vital component of the free enterprise system.

NARD members are primarily family businesses. They have roots in America's communities. The neighborhood independent druggist typifies the reliability, stability, yet adventuresomeness that has made our country great.

As owners, managers and employees of independent pharmacies, our members are committed to legislative and regulatory initiatives designed to provide them a fair chance to compete. We appreciate the opportunity to appear before the Subcommittee to present our recommendations regarding the authorizing legislation for the Federal Trade Commission (FTC).

Competition in retail pharmacies is alive and well. Competition is an incentive for efficiency and the price competition in retail pharmacy is typically greater than can be found among other providers of health services and products.

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* Thomas A. Luken, (D-OH), Chairman
MAJORITY: (8-D) Representatives Luken, James J. Florio (NJ), W.J. Billy Tauzin (LA), Jim Slattery (KS), Gerry Sikorski (MN), Jim Bates (CA), Rick Boucher (VA) Jim Cooper (TN)
MINORITY: (5-R) Bob Whittaker (KS), Thomas J. Tauke (IA), Michael Bilirakis (FL), Dan Schaefer (CO), Sonny Callahan (AL)

Nonprofit Competitors

A recommendation to prohibit unfair competition by nonprofits, including government, was nearly the top priority (#3) of the 1800 national delegates to the 1986 White House Conference on Small Business:

WHITE HOUSE CONFERENCE RECOMMENDATION

> ***3.** *Government at all levels has failed to protect the small businesses from damaging levels of unfair competition at the federal, state and local levels, therefore laws, regulations and policies should:*
>
> *a. Prohibit unfair competition in which nonprofit tax-exempt organizations use their tax-exempt status and other advantages in selling products and services also offered by small businesses.*
>
> *b. Prohibit direct, government-created competition in which government organizations perform commercial services.*

To implement these objectives, we concur with the recommendations of the Business Coalition for Fair Competition (BCFC) expressed in the Introduction to the 1987 publication "Unfair Competition" (page 1):

> "These goals should be achieved by, but not limited to, the following ways:
>
> Nonprofits: Tax-exempt entities should not be permitted to use their tax status or postal rates to compete with commercial providers of products and services. Nonprofit organizations receiving government grants and contracts, including federally funded research and development centers, should be prohibited from using federal dollars to compete with products and services provided by the private sector. Nonprofits engaging in commercial activities should be prohibited from doing so while enjoying exemption from government regulations such as antitrust laws, worker's compensation, and health and safety rules.
>
> Governments: New laws at all levels, particularly at the federal level, should require strict government reliance on the private sector for performance of commercial-type functions. When cost comparisons are necessary to accomplish conversion to private sector performance, laws must include provision for fair and equal cost comparisons. Funds controlled by a government entity must not be used to establish or conduct a commercial activity on U.S. property. Government regulated utilities should be prohibited from using their government favored position to compete in markets already served by small businesses."

Commercial nonprofits have surfaced in many business sectors, principally among those industries impacted, as identified by the BCFC are:

> *Testing Laboratories: University facilities and equipment are being used to perform contract analytical services in competition with private, tax-paying labs.*
>
> *Retail Sales: Universities offer on-campus retail sales of items such as personal computers in competition with local private retail merchants.*
>
> *Veterinary Medicine: Nonprofit organizations such as the Humane Societies operate full-service veterinary clinics serving clients in competition with veterinarians in private practice.*
>
> *Video Production: Universities and Public Broadcasting stations using subsidized equipment compete with private video producers for commercial contracts.*
>
> *Recreation: The YMCA as a "nonprofit" is marketing health spa memberships in direct competition with private health spas.*
>
> *Travel: Nonprofit, tax-exempt organizations, such as universities, alumni associations, and local governments engage in the commercial sale of travel.*
>
> *Prescription Drugs: Nonprofit hospitals purchase prescription drugs at volume discounts and resell them in competition with private pharmacies.*

Some of the commercial nonprofits that are active in our marketplace claim that they are not purchasing under the 1938 Act. Mr. Chairman, enactment of your legislation, H.R. 186, which would require disclosure of 1938 Act purchases by nonprofit entities would provide invaluable assistance in sorting out those commercial nonprofits in our marketplace that have radical price advantages. We urge the Subcommittee to consider whether the FTC and state Attorneys General are the more appropriate entities to collect the disclosure and monitor subsequent activities. Regarding FTC, hope springs eternal and in any case the leadership at the FTC is bound to change.

On the general subject of commercial nonprofits, whether they exploit the 1938 Act or not, although it is our view that FTC has jurisdiction over blatant commercial activities by nonprofits, we recommend that the Subcommittee consider including an amendment to the FTC authorization that would clarify the Federal Trade Commission Act jurisdiction in cases involving the commercial activities of nonprofit organizations including the selling of prescription drugs in direct competition with retail pharmacies.

As mentioned at the outset, our members dispense 70% of all prescription drugs in the United States. Recent reports indicate that prescription drugs account for 60% (41.6 to 78.5%) of a typical NARD member's sales volume. Of course, as you are all familiar, the balance of our members' sales volume includes products such as over the counter drugs, health and beauty aids, sundries, greeting cards, gifts and related products.

Additionally, more than 60% of our members are involved with the sale or rental of home health care products ranging from walkers to high tech parenteral products. In all these product categories, we are confronted by profit and commercial nonprofit competitors.

We would like to focus the Subcommittee's attention on one aspect of commercial nonprofit activity in our industry: mail order dispensing of drugs and related products.

The AARP Pharmacy Services and the Arthritis Foundation are prototypical examples of commercial nonprofits in the mail order retail drug marketplace. They pitch savings and drugs at "prices below retail". They pitch as ostensible "savings" the difference between brand and generic prices as if generic drugs are not available through independent retail pharmacies. Of course, exemption from state and local tax is just one of many subsidies they enjoy. AARP, for example, receives an annual federal postage subsidy of approximately $6,500,000. AARP's priority membership pitch is their nonprofit pharmacy services, which of course, are sent out to millions via the nonprofit mailing subsidy.

AARP's drugstore business operates under a "halo" bar none. The AARP is a highly regarded organization which in many instances does great service for the elderly -- incidentally, AARP members are not typically charity cases, nor is a means test applied to determine eligibility. Yet as a nonprofit entity, they have no business in the pharmacy business unless they pay the full cost of doing business.

To add insult to injury, in 1985, the FTC published, in cooperation with the AARP, a consumer brochure "Healthy Questions, How I Talk To and Select Physicians, Dentists, and Vision Care Specialists" with a section on pharmacists and pharmaceutical products. Thus, the agency responsible for enforcement collaborated in a very public way with one competitor in the prescription drug marketplace, albeit, a nonprofit competitor utilizing unorthodox dispensing. The NARD's correspondence with then Chairman Miller suggesting that the National Council on Patient Information and Education (NCPIE) (chaired by the Honorable Paul Rogers) would be an appropriate vehicle (non-competitor) for the distribution of such information. The Chairman's response to NARD is enclosed. Ironically, Chairman Miller cited the fact that drafts of the FTC/AARP publication were reviewed by the American Pharmaceutical Association (APhA) and the National Association of Chain Drug Stores (NACDS). He brought to our attention the fact that neither organization raised any questions regarding mail order pharmacies nor expressed any concern about the FTC publishing the pamphlet in conjunction with AARP. Neither APhA nor NACDS represent the proprietary interest of the independent retail pharmacists. In fact, the former represents pharmacists engaged in such unorthodox dispensing and AARP is a member in good standing in the latter.

A related concern is whether the mail order dispensing companies, for profit or commercial nonprofit such as AARP, are complying with consumer protection statutes and regulations in the respective states where they are doing business. These laws were designed to safeguard the health and welfare of the residents in such states. In the last several years, the regulation of such practices has been increasingly considered by state legislatures and relevant state agencies.

State legislators have acted to control such unorthodox dispensing from beyond their jurisdiction and it appears are expressing on an increasing basis a willingness to address the public health risks and anticompetitive aspects in even a more comprehensive way. This unorthodox method of dispensing prescription drugs presents a threat to public health, in part, by severing the physician-patient-pharmacist relationship.

For similar reasons, the Subcommittee on Oversight and Investigations of the Energy and Commerce Committee in its April 1986 report Dangerous Medicine recommended (at page 8) that the Congress should:

> "Closely examine the mail order dispensing of pharmaceuticals to determine whether or not the public health risks of this growing practice are reasonable."

After all, the ultimate consumer is not just acquiring a commodity such as a fountain pen or note pad. The proper dispensing of prescription drugs and related matters of patient care are far more comprehensive than the delivery of a commodity. That is why state legislatures have developed comprehensive, rational regulatory schemes to protect consumers. One of our primary concerns is that companies, both for profit and commercial nonprofit, have undertaken an effort to intimidate states, in particular state legislators. They mistakenly argue that regulation of the practice of pharmacy and related consumer concerns amount to nothing more than commodities moving in commerce from one state to another. It's been reported to us that they claim that any effort to subject the mail order businesses to comparable standards for orthodox physician-patient-pharmacist dispensing would violate antitrust laws and that the FTC concurs with this view.

Consequently, we request that the Subcommittee determine the extent to which a conspiracy has been formed to undermine the application and enforcement of state statutes and regulations designed to protect the consumer and determine to what extent, if any, such activities are being encouraged by the FTC.

The elimination of unfair competition with independent pharmacies is an essential component of our agenda for the 100th Congress. Especially obnoxious is unfair government competition. It is our position that no small business should tolerate a government allocation of their taxes for projects or programs that unfairly compete with the very sources of the tax revenue: business generated by enterprising independent retail pharmacists.

Regarding the government competition with independent retail pharmacists which we represent, Justice Powell observed *Jefferson Pharmaceutical Association, Inc. v. Abbott Laboratories, et al*, 103 Supreme Court 1011 (1983), at footnote 17 the following:

> "In one important sense, retail competition from state agencies can be more invidious than that from chain-stores, the particular targets of the Robinson-Patman Act. Volume purchasing permits any large, relatively efficient, retail organization to pass on cost savings to consumers, and to that extent, consumers benefit merely from economy of scale. But to the extent that lower prices are attributable to lower overhead, resulting from federal grants, state subsidies, free public services, and freedom of taxation, state agencies merely redistribute the burden of costs from the actual consumers to the citizens at large. An exemption from the Robinson-Patman Act could give state agencies a significant additional advantage in certain commercial markets, perhaps enough to eliminate marginal or small private competitors. Consumers, as citizens, ultimately will pay for the full costs of the drugs sold by the state agencies involved in this case. Because there is no reason to assume that such agencies will provide retail distribution more efficiently than private retail pharmacists, consumers will suffer to the extent that state retail activities eliminate more efficient, private retail distribution systems."

We urge the Subcommittee to consider oversight hearings on the enforcement of the Portland Retail Druggists case which held that pharmacies could not use the Nonprofit Institution Act as a shield from the Robinson-Patman Act and the landmark Jefferson County decision concurring with NARD's position that the price discrimination practices of the Robinson-Patman Act extended to the sale of pharmaceutical services and products to state and local government pharmacies for resale in competition with NARD members.

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COMPETITION

SPRING 1986

FYI

COMMERCIAL NONPROFITS

A Threat to Free Enterprise and Public Health

Few issues have galvanized the American business community in recent years quite like unfair competition from commercial nonprofits.

Both the numbers and economic influence of nonprofit organizations have grown tremendously in recent years. Their income now represents more than 9 percent of GNP—three times what it was after World War II. And those figures don't even include sales by tax-exempt entities such as universities and state institutions.

All these commercial nonprofits enjoy a variety of benefits not afforded their taxpaying competition, including special treatment or exemption from Social Security payments, unemployment insurance, minimum wage laws, securities regulation, antitrust laws, postal rates, and more. It's even been demonstrated that commercial nonprofits tend to concentrate where taxes are the highest.

PERVASIVE PROBLEM

The problem of unfair competition by commercial nonprofit organizations is pervasive. Many trade associations have banded together in the Business Coalition for Fair Competition (BCFC) to combat the rapid and unregulated expansion of government and nonprofit entities into commercial markets. Among the members of BCFC are associations representing travel agents, engineers, nurserymen, bus owners, and independent retail pharmacists. NARD serves on the BCFC Executive Committee.

Businesses represented in the upcoming White House Conference on Small Business have also made unfair competition by commercial nonprofits a top priority. Overall, the issue of unfair competition by commercial nonprofits is #3 of the top issues to be addressed at the conference.

The Small Business Administration has also joined in the struggle. It has published a detailed report on the problem, *Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the '80s*. In his appearance at NARD's 1985 legislative conference, SBA Office of Advocacy Chief Counsel Frank Swain told pharmacists that "when a nonprofit institution, on a continual, regular basis, decides it wants to sell something, whether it's related or unrelated to its principal field of endeavor, they at least ought to do it under the same rules and regulations that everybody else in the small business community has to live with."

PUBLIC HEALTH THREAT

While unfair competition from commercial nonprofits is a problem for many industries, its manifestation in the prescription drug market goes beyond fair competition and free enterprise: it threatens public health.

The root cause of the subterranean drug diversion market is the abuse of the 1938 Nonprofit Institutions Act by commercial nonprofit organizations. The 1938 act—passed to provide an exemption to the Robinson-Patman Act for truly charitable institutions—was not intended to reward certain competitors while bankrupting others or to provide the catalyst for an illegal, life-threatening marketplace for diverted drugs.

And yet that is precisely what has happened. The Nonprofit Institutions Act today is abused by openly commercial nonprofit entities to protect themselves from discriminatory pricing crimes under the Robinson-Patman Act. And it is that exemption that drug diverters are now exploiting to reap enormous, illegal profits from the nation's drug distribution system.

In short, if we can put an end to discriminatory pricing, we will put an end to the diversion market. They are inextricably linked.

LEGISLATIVE SOLUTIONS

Landmark legislation, H.R. 4820, to put discriminatory pricing behind us once and for all has recently been introduced. Oversight Subcommittee Chairman John Dingell's (D-MI) bill will, among other remedies, ban the sale of prescription drugs or samples by nonprofit institutions not for their own use, as well as the sale of drugs donated or supplied at a reduced price to charitable institutions.

A bill complementing that legislation has been introduced by Rep. Thomas Luken (D-OH). The measure would require annual registration with the FDA of all nonprofit entities engaged in the provision of health services and the dispensing of prescription drugs that wish to qualify for the charitable exemption to the Robinson-Patman Act as defined under the terms of the 1938 Nonprofit Institutions Act.

These actions by Congress are important steps in doing away with the threat to public health and fair competition created by discriminatory pricing. But there is much political legwork yet to be done to eliminate other forms of unfair competition by commercial nonprofit institutions.

BCFC has published a guide, *Unfair Competition in the States: How to Combat Competition from Nonprofit Business Ventures*, to help you address this problem. It includes detailed information on how to fight unfair competition in your state. If you would like a copy of this valuable resource, send $5 to Unfair Competition, National Association of Retail Druggists, 205 Daingerfield Rd., Alexandria, VA 22314.

FYI, a monthly perspective on topics of interest to pharmacists, is provided as a service by the National Association of Retail Druggists.

* H.R. 1207 in the 100th Congress, passed the House on May 4, 1987. The Senate bill, S. 368, is currently in the Finance Committee.

Application For Entry Of Legal Judgment

National Association of Retail Druggists
National Association of Pharmacists
Political Action Committee

Plaintiffs

vs.

Nonprofit Competitors of
Independent Pharmacists

Defendants

Extra Civil Action CC 1986

As a taxpaying citizen and an independent retail pharmacist, I applaud the investigation of the billion-dollar illegal prescription drug diversion market conducted by the U.S. House of Representatives Committee on Energy and Commerce. This investigation has focused national attention on industry practices, principally price discrimination for "nonprofit" institutions and the havoc that such price discriminating practices have spawned both in terms of unfair competition for pharmacists and our customers, and the threat to consumer welfare posed by the risk of adulterated and substandard quality black market drugs.

It Is Ordered, Adjudged And Decreed that I am correct that, when Congress in 1938 authorized price discrimination, it was to assist institutions supported by charity to aid indigents, or in today's terms, to aid those in the category of "uncompensated care," not to establish a preferred class of commercial nonprofit competitors.

It Is Expressly Decreed that the intended beneficiaries of the 1938 law, typified by alms houses or paupers' hospitals, were supported by subscriptions and were making their services available to patients who could not pay for the services. Today, nonprofits that are engaging in competition with for-profit firms that pay federal, state, and local taxes for the privilege of doing business, claim the protection of this law. Few, if any, of their patients receive free care. In fact, in order to obtain care, you must be a paying customer or be covered by Medicare, Medicaid, or insurance. To call Kaiser, for example, a "charity" is to abuse the term. To permit these competitors to acquire prescription drugs at radically reduced prices that are not based on volume purchases or other frugal business prices is totally unacceptable and a perversion of a depression-era law that forgave price discriminating crimes that benefited charities.

It Is Further Adjudged that the American consumer is the primary victim of such pricing practices and black market diversion. It is impossible to place a value on the potential health risks, yet the economic costs are clear. The consumer subsidizes such purchases by tax-exempt nonprofits by paying higher taxes, and more in retail pharmacies such as mine for prescription drugs as a result of cost-shifting caused by such purchases. The consumer is further victimized since these commercial nonprofits fail to pass on any savings associated with price discrimination.

It Is Finally Ordered that discriminatory pricing for noncharities, known as commercial nonprofits, including hospitals and their subsidiaries and satellites, HMOs, clinics, and mail order organizations, shall be terminated.

National Foundation For
Women Legislators
Inc.

NEWSLETTER • May 1987 • Serving elected women legislators since 1938

Point / Counterpoint

This month, your NFWL newsletter asked Mr. Delbert D. Konnor, Director of Professional Services of the A.A.R.P. Pharmacy Services, and Mr. John M. Rector, General Counsel, Vice President Government Affairs of The National Association of Retail Druggists to comment on the issue of mail service pharmacy.

Counterpoint

Regulating The Practice Of Pharmacy

The regulation of the practice of pharmacy has been long-established to be exclusively within the purview of state legislatures. The regulation and control of those in a learned profession such as pharmacy is illustrative of the endeavors impacting the public health and welfare which our Constitution and its several amendments reserved to the states.

The respective states consequently have enacted consumer protection statutes and appropriate regulations controlling the practice of pharmacy and regulating pharmacy as a business. Any discussion or consideration of unorthodox dispensing of prescription drugs including dispensing by out-of-state businesses through the mail must address both the professional and commercial consequences.

Regarding the regulation of this unorthodox method of dispensing prescription drugs, the National Association of Retail Druggists continues to have serious concerns that the businesses engaging in this type of dispensing fail to comply with rules, regulations and laws in the respective states where they are doing business. These were designed to guard the health and welfare of the residents in such states. In the last several years the regulation of such practices has been increasingly considered by state legislature and relevant state agencies.

Many state legislators have acted to control such unorthodox dispensing from beyond their jurisdiction and it appears are expressing on an increasing basis a willingness to address the public health risks and anticompetitive aspects in even a more comprehensive way. This unorthodox method of dispensing prescription drugs presents a threat to public health, in part, by severing the physician-patient-pharmacist relationship.

States including Arkansas and Louisiana have enacted laws and in the states of Wisconsin and California, Attorneys General have issued opinions addressing the need to license such out-of-state businesses and to regulate the condition of the drugs and prescription medical devices which are sent into a state by such businesses. The Utah Attorney General's office has, just last month, issued an informal opinion reiterating support for a statute which requires persons advertising the filling or refilling of prescription drugs to residents of Utah to be a Utah licensed pharmacist. This statute, like the others, is even-handed and properly makes no distinction between the state pharmacies and out-of-state mail order businesses. These laws seek only equitable consumer protection for the residents of their states. Other states require face-to-face consultation between the pharmacist and the patient, continuing education for pharmacists, or limit the number of technicians who can be involved in the dispensing process so as not to dilute the involvement of the pharmacist who is the prescription drug expert.

After all, the ultimate consumer is not just acquiring a commodity such as a fountain pen or note pad. The proper dispensing of prescription drugs and related matters of patient care are far more comprehensive than the delivery of a commodity. That is why state legislatures have developed comprehensive, rational regulatory schemes such as pharmacy practice acts. One of our primary concerns is that companies both for profit and nonprofit have undertaken an effort to intimidate states and in particular state legislators. They mistakenly argue that regulation of the practice of pharmacy and related concerns amount to nothing more than commodities moving in commerce from one state to another. These lobbyists even argue that mail order saves money. At best, this is a close call. Recent studies indicate that, especially with the elderly, costs exceed those of pharmacies. To the extent that mail order advocates attempt to encourage contracts that give preference to this unorthodox method of dispensing, they are likely to encounter laws such as H.B. 1433 recently signed into law in Arkansas which prohibits employers providing pharmacy services in a health care program from requiring utilization of out-of-state mail order drugs and further prohibits any incentive for such dispensing.

Congress has expressed concerns especially abouth the health care consequences of mail order dispensing. For example, last spring, the U.S. House of Representatives Committee on Energy and Commerce in its report "Dangerous Medicine" called on Congress "to closely examine the mail order dispensing of pharmaceuticals to determine whether or not the public health risks of this growing practice are reasonable." Additionally, the Committee has reported to the House legislation to curb the selling of drugs by nonprofits who acquire by special charity prices and then sell the drugs in the illicit market. Bogus charities are also involved. For example, the Committee in its investigation revealed prosecutions brought by the U.S. Department of Justice against corporate officials of a drug wholesale company who fraudulently represented that they were purchasing drugs at charity prices for the Indiana Chapter of AARP. These drugs were diverted into the illegal market and eventually the corporate officials were sent to prison. As if to add insult to injury, the irony of this bogus charity scheme is that AARP hardly qualifies as a charity under the special 1938 exemption to the antitrust price discrimination sanctions.

Such organizations appear basically to want to preempt well-established state laws in order to maintain a competitive advantage in having to meet the standards of practice or pay the cost of doing business in the various states. In fact, Congress has also taken an interest in the failure of mail order businesses to, for example, collect state taxes which are due. Of particular concern to the pharmacists who own and operate 30,000 independent pharmacies where 75,000 pharmacists practice their profession is the involvement in this marketplace and legislative arena of nonprofit organizations. The AARP Pharmacy Services which operate as a nonprofit subsidiary of parent nonprofit AARP, is in the mail order prescription drug dispensing business. With such nonprofit competitors engaging in commercial activity, the playing field is substantially tilted. This aspect of mail order dispensing is being addressed in the House of Representatives by the Ways and Means Committee and was selected as a top priority by the delegates from each of the states to the White House Conference on Small Business in 1986.

Certainly, the AARP is a highly regarded nationally recognized organization which in many instances does a great service to the elderly, but as a nonprofit entity, they have no business in the prescription drug business.

In many states, there are active affiliates of the national Business Coalition for Fair Competition addressing the wide range of indefensible commercial activities by nonprofit entities. There will be extensive legislative activity on this particular aspect of mail order dispensing.

The public policy matters regarding the health consequences of unregulated dispensing are too complex and far too numerous to enumerate. In our view, the bottom line is that mail order firms cannot provide adequate health care to patients they never see. Face-to-face communication between patient and pharmacist has been a vital component of pharmacy practice since its inception. Pharmacists interact daily with patients in their stores; they monitor their patients' health status, assess their compliance with drug therapy, answer questions, make recommendations, and communicate with their physicians. Patients know they can count on the pharmacist to provide expert advice on drug therapy on the spot and personally attend to their individual health care needs. This face-to-face communication is a key element in ensuring that the public health will be protected.

In summary, it's the practice of pharmacy in its full manifestation that provides the reliability and the protection the consumer has grown to and is entitled to expect. Our members interact with more than 18 million customers a day, and it's these interactions which have led year-in and year-out for the public to select pharmacists, retail druggists, as the most trusted secular profession. To state the obvious, these essential trust relationships were not developed through the mail box

Legislative Conference 1985

Part 1

When the problems facing the profession of pharmacy are acute, decisive action is essential. The dual and related problems of discriminatory pricing and the fed's recent campaign to eliminate pharmacists' earned discounts from the Medicaid program are two such acute challenges.

Responding to these challenges, NARD took a fresh approach in its 17th Annual Conference on National Legislation and Public Affairs and targeted those two issues for concerted political action.

Speakers were carefully selected who were key players on these two fronts. Events were planned for maximum political impact. Personalities like Health and Human Services Inspector General Richard Kusserow, the architect of the proposal to eliminate pharmacists' earned discounts, appeared before the conference, as did Frank Swain, chief counsel for the Small Business Administration's Office of Advocacy, the source of one of the first definitive reports on the discriminatory pricing advantages commercial nonprofits enjoy in the marketplace.

Representative Gerry Sikorski (DFL-MN), a member of the House Oversight and Investigations Subcommittee, told pharmacy leaders at the conference that the subcommittee has launched a major investigation into drug diversion spawned by such discriminatory pricing practices.

The pages that follow recount a legislative conference marked by decisive victories for independent retail pharmacy—victories born of hardball politics played relentlessly both at home and in the nation's capital.

Look for part two of our report next month.

Legislative Conference 1985

Arthur Lerner, assistant director, Bureau of Competition, Federal Trade Commission

Arthur Lerner

FTC Act Restrains Scrutiny of Unfair Nonprofit Competition

When Congress passed the law that created the Federal Trade Commission in 1914, said Arthur Lerner, assistant director of the FTC's Bureau of Competition, charitable institutions were not engaged in commerce. But, Lerner told pharmacy leaders at NARD's legislative conference, that's "certainly a very questionable proposition today."

One of the problems pharmacy faces in its fight to have nontaxpaying organizationas operate under the same rules as commercial enterprises is that the FTC Act specifically precludes the commission from investigating the activities of commercial nonprofit organizations. "The legality of someone's conduct should depend on what they do, not who they are," said Lerner.

"In that respect, we face not only the Nonprofit Institutions Act exemption from the Robinson-Patman Act, but also the Federal Trade Commission Act itself," said Lerner. He noted that the FTC attempted to change that section of the act in the mid 1970s, but failed because the commission was "blitzed by charities." He added that the commission would support appropriately crafted legislation extending their authority to nonprofit entities if it were introduced today. Conference speaker Frank Swain of the Small Business Administration has already called for an amendment to the FTC Act to do just that.

Free competition

The commission does, however, have jurisdiction over the behavior of preferred provider organizations (PPOs), as well as group purchasing arrangements and state regulations that inhibit competition. "Our general philosophy at the commission is to let the marketplace work. We're very skeptical of government regulation that hinders business' freedom of competition," said Lerner. "You all are doing the work that we at the commission talk about, and from all I can tell, you're doing a good job of it."

Lerner has taken a particular interest in PPOs. He explained that while buyer-controlled PPOs rarely violate antitrust statutes, the FTC looks at provider-controlled PPOs skeptically. In general, however, Lerner said the government considers most PPOs to be procompetitive and hesitates to interfere. But if a PPO uses its competitive power to try to fix prices, or if it exercises unreasonable "exclusionary behav-

609.

Legislative Conference 1985

ior'' to keep competitors out of the market, then the FTC may find its behavior actionable.

As far as group buying by pharmacists is concerned, Lerner said, ''I don't see any substantial antitrust questions that would come up under the Sherman Act, the FTC Act, or the Robinson-Patman Act,'' as long as the buying group is not too large.

Although Lerner said he is unaware of any FTC investigation of pharmacist's behavior in the marketplace, he noted that the commission currently does have investigations under way in the pharmacy field exploring state regulations that limit truthful advertising by pharmacists.

It was good news for independent retail pharmacy and NARD, which has worked for a narrow exemption from the antitrust laws to allow pharmacists to bargain competitively, when Lerner said, ''I think you can make a reasonable argument that [collective bargaining by pharmacists] should be legal under the antitrust laws.''

Rep. Gerry Sikorski

Taking a Hard Line on Discriminatory Pricing

Congress has a responsibility to ensure that the nonprofit exemption to the Robinson-Patman Act ''is not abused and and undermined and that retailers are getting a fair shake,'' Rep. Gerry Sikorski (DFL-MN) told pharmacists at NARD's legislative conference.

Sikorski, a member of the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, hinted that the scope of a current subcommittee investigation of drug diversion spawned by the existence of discriminatory drug prices could rival the subcommittee's widely publicized probe of the General Dynamics Corporation's defense contract abuses. Rep. John Dingell (D-MI) chairs the Investigations Subcommittee as well as the full Energy and Commerce Committee.

Representative Gerry Sikorski (DFL-MN)

Bogus drugs

Sikorski has taken a special interest in the ''gray market'' in pharmaceuticals, initially a year ago in the wake of the bogus Ovulen 21 birth control tablets that recently made their way into legitimate drug distribution channels. He told pharmacists at the conference that the gray market—''the mechanism in existence whereby bargain-priced drugs get into the retail chain and make their way to the public''—is exacerbated greatly by the existence of differential drug prices available to commercial nonprofit entities.

''I'm not against a bargain,'' said Sikorski, but he warned that the effect of the Nonprofit Institutions Act loophole to Robinson-Patman is that some commercial nonprofits ''are seduced or reduced into selling products in competition with the private sector.'' He described in particular the ''U-Boat'' technique, where drugs sold at discriminatory prices for use overseas are diverted into the U.S. market, either by having shipments rerouted or simply by diverting drugs on paper.

''My concern is yours,'' said Sikorski. ''Counterfeit, inferior, outdated drugs can fit through the [Nonprofit Institutions Act] loophole, and that's bad for business.'' He told pharmacists that ''tilted playing fields make for bad economic and social policy. I'm not waiting for the investigation. I think we need modification now, just on the record we have.''

Diversion scams

Sikorski further noted that ''enterprises are emerging that are set up solely to massage the loophole in the Nonprofit Institutions Act.'' He described a ''Hospital Pharmacy Advancement Program'' offered by a diverter, under the guise of ''improved pharmacy inventory control,'' where the pharmacy increases its drug purchases at discriminatory prices, and the diverter picks up the extra drugs and pays the hospital a profit on their differential price. ''Our investigation is trying to determine the scope of the problem,'' said Sikorski.

The congressman asked NARD members to send information on the diversion problem to the Oversight and Investigations Subcommitee to assist them in their inquiry into diversion caused by discriminatory pricing policies. He urged NARD members to send evidence of price discrimination and drug diversion to NARD's clearinghouse on price discrimination and commercial ''nonprofit'' institutions.

''Five cards, from five druggists, on a thing like this is an outpouring,'' said Sikorski. ''It's an avalanche. We will take note.''

Frank Swain

Going to Bat for Small Business and Pharmacy

Frank Swain has seen the enemy, and it is government competition. Swain, a Reagan appointee, is chief counsel for the Small Business Administration's Office of Advocacy. His battleground in

Legislative Conference 1985

defending the interests of small business is the same as NARD's in defending pharmacy: to see to it that commercial "nonprofit" organizations compete under the same rules as for-profit businesses.

In addition, Swain's charge at the Small Business Administration brings him in direct involvement with recent HCFA policy changes that threaten to eliminate the discounts pharmacists earn for prudent business practices.

Frank Swain, chief counsel, Small Business Administration Office of Advocacy

Persuasive powers

"We're open to a lot of complaints and petitions from people in the private sector to talk about the problems that governmental actions create, and how we might go about solving them." Swain told pharmacists at NARD's legisltive conference. "If you're having a problem with a regulation that's being written or unwritten by the Department of Health and Human Services, we have persuasive powers," he said.

Swain's office has responsibility for enforcement of the Regulatory Flexibility Act, which requires that the impact of proposed federal agency actions on small business be analyzed before implementation.

Swain's overriding concern in his effort to act as an advocate for small business is government competition, both direct and indirect. He said government competition with the private sector is "sort of like kudzu (a prolific plant originally introduced to prevent erosion, but now growing out of control in southern states), it just keeps growing and you can't stop it."

Distinctions blurred

Tax breaks and other subsidies granted to commercial "nonprofits" but not to tax-paying enterprises, said Swain, are the most insidious form of government competition. Swain, whose Office of Advocacy recently produced a provocative report on nonprofit competition (see May '85 *Journal* cover story), noted that "we have clearly crossed the line from a noble social goal into sales to the everyday, ordinary consumer. You see the wall between the profit and the nonprofit continually being blurred." He reported that no issue has generated more mail to his office than that of indirect government competition with the private sector.

The wall between the profit and nonprofit is continually being blurred

Government competition is sort of like kudzu, it just keeps growing and you can't stop it

"Nobody is trying to put the Girl Scouts out of the business of selling cookies," said Swain, "but when a nonprofit institution, on a continual, regular basis, decides it wants to sell something, whether it's related or unrelated to its principal field of endeavor, they at least ought to do it under the same rules and regulations that everybody in the small business community has to live with."

Swain cited the results of a Yale law school study that found that in states with higher tax rates the relative number of nonprofit organizations is higher, and vice versa. This suggests, said Swain, that businesses in high-tax states tend to opt for nonprofit status to reduce costs. "The overhead of nonprofits can be significantly affected when they are exempted from federal income taxes, state income taxes, or local property taxes, or if they have special mailing

In workshop sessions prior to their Capitol Hill visits, pharmacists planned strategy for lobbying efforts on the legislative conference's two target issues—earned discounts and discriminatory pricing.

privileges and certain specific exemptions from specific laws."

"Oddly enough," Swain noted, "the Federal Trade Commission cannot investigate nonprofits in the health care industry by virtue of the law." Swain's recent report on nonprofits called for an amendment to the FTC Act to change that.

The Small Business Administration Office of Advocacy is looking into the impact of government tax breaks, subsidies, and other benefits afforded commercial nonprofits. "What we are trying to do is remind agencies that the traditional reason for giving an advantage to a nonprofit has evaporated."

Subsidies to commercial nonprofits are the most insidious form of government competition

Swain's office has also urged Congress to hold hearings to investigate the problem. "Ultimately," said Swain, "it's going to have to be clarified by the Congress." During NARD's legislative conference pharmacists asked their congressional delegations to cosponsor legislation drafted by NARD that clarifies Congress' original intent when it created the nonprofit exemption to the Robinson-Patman Act.

Trial in secret

During the question and answer period, Swain took on another example of inappropriate government intrusion in the private sector—HCFA's recent proposed policy changes in the Medicaid drug program. NARD Executive Committee member Don Arthur explained to Swain how HCFA has attempted to push through the major policy change without benefit of due process and that the proposal would adversely affect all retail pharmacies.

"My guess would be that they would try to say that it was just sort of a management change," Swain suggested. "But we don't necessarily let an agency rest on that argument."

"The normal standard," said Swain, "is that if a rule is proposed that would have a significant economic effect on a substantial number of small businesses, then there has to be an analysis accompanying the rule." He told pharmacists at the conference that he would look into NARD's concerns regarding the HCFA policy change. His office has subsequently designated its deputy chief counsel to assess HCFA's failure to comply with federal due process requirements, including adherence to the Regulatory Flexibility Act.

In response to a question about the audit report from Inspector General Richard Kusserow's office that generated the policy change, Swain noted that "the inspector generals do cut a wide swath.

"But," said Swain, "I don't believe in trial in secret."

Swain also gave legislative conference participants an "insiders" briefing on the upcoming White House Conference on Small Business, and how his office has been working closely with NARD to have independent retail pharmacists represented among delegates to the conference.

Study Finds Not-For-Profit Hospital Chains Not Repaying Society for Tax Breaks

Although no study is necessary to demonstrate that it is patently unfair for an organization that pays no taxes to compete head-to-head with taxpaying, private sector businesses, a recent study suggests that nonprofit health care institutions are not even offering the public the benefits they use to justify their tax-exempt status.

The article below, summarizing the study, is reprinted with permission from a recent issue of Modern Healthcare.

Not-for-profit hospital chains receive substantial social subsidies in the form of tax breaks and access to tax-exempt financing, but they have failed to repay this social investment adequately, a new study of investor-owned and not-for-profit hospital chains shows.

The study, published in the *Harvard Business Review*, says not-for-profit hospital chains are less efficient than investor-owned chains, based on an analysis of various financial and productivity measures. It is the newest contribution to a growing body of literature analyzing the differences between investor-owned and not-for-profit hospitals.

The study takes a new approach by including the cost of social subsidies in its analysis, said Regina Herzlinger, its coauthor and a professor at Harvard University's Graduate School of Business Administration, Cambridge, MA.

These subsidies arise from the tax system, which doesn't require not-for-profit hospitals to pay taxes and gives them access to low-cost, tax-exempt financing. Investor-owned hospitals also get social subsidies from such tax breaks as accelerated depreciation, the investment tax credit, and access to tax-exempt industrial development or revenue bonds.

The hidden costs of social subsidies have been overlooked by previous studies, but they should be considered in the ongoing debate over the relative costs of for-profit and not-for-profit health care, Herzlinger said. When these costs are incorporated in a financial analysis, investor-owned hospital chains appear better capable of financing their capital needs with internally generated funds than not-for-profit chains, she said.

Analysis

Herzlinger's study found that 17 cents of every dollar invested in a not-for-profit hospital in 1981 came from social subsidies, broadly defined as costs hospitals would have assumed if they were taxable institutions. By contrast, social subsidies accounted for only two cents of every dollar invested in investor-owned chains.

The study's data is based on results in 1977 and 1981 for 585 hospitals owned or managed by six investor-owned chains and 141 hospitals owned or managed by seven not-for-profit chains. But Herzlinger said her findings apply to thousands of freestanding community hospitals that closely resemble the hospitals she studied.

Not-for-profit chains have smaller debt burdens than investor-owned chains, in part, because of social subsidies, Herzlinger said. "They didn't borrow as much because they didn't have to." In 1981, not-for-profit chains' debt represented 66 percent of their total capitalization, compared with 73 percent for investor-owned chains.

Most of the equity base of not-for-profit hospitals consists of physical assets that have increased in value but are of little financial benefit until they are sold. Investor-owned chains retain a much larger percentage of their earnings, which can be used much more easily to finance the replacement of facilities, said Herzlinger.

Calculations based on balance sheets adjusted for inflation and social subsidies indicate not-for-profit chains are understating the depreciation expense of physical assets and failing to earn enough operating income to cover the replacement costs of existing plant and equipment, Herzlinger said. The not-for-profit chains "haven't priced their services at a level sufficient to replace their assets" and are consuming their resources, endangering their future ability to deliver services."

Payoffs

Social subsidies would make sense if not-for-profit hospitals charged lower prices, provided greater access to services or rapidly replaced plant and equipment, relieving future generations of this responsiblity, Herzlinger said. Subsidies ought to result in some clear benefits to society, or they're not justified, she said.

But her study found no significant differences in the prices, payer mix or operating costs of investor-owned and not-for-profit hospital chains. Instead, it found that investor-owned chains make more efficient use of hospital beds while utilizing fewer full-time employees. Not-for-profit hospitals have kept staffing levels relatively high and beds open because they're oriented toward physicians who want these resources available, she said.

By concentrating on physicians' needs and letting their facilities age, not-for-profit hospital chains have been "much more shortsighted than the for-profit chains," said Herzlinger. Both segments of the industry had high credit standings and access to capital under cost-based reimbursement, which guaranteed hospitals payment for their costs. But investor-owned chains responded to reimbursement incentives to replace facilities and equipment at a more rapid pace than not-for-profit chains, she said.

Social subsidies would make sense if not-for-profit hospitals charged lower prices, but they don't

Other views

Craig Coelen, the author of a report on hospital ownership and comparative hospital costs for an Institute of Medicine study on for-profit health care published this year, disputed the contention that the prices charged by investor-owned and not-for-profit chains are essentially equal.

The Institute of Medicine study found that routine hospital charges per adjusted discharge were "about the same" for investor-owned and not-for-profit hospitals. However, compared with freestanding not-for-profit hospitals, ancillary charges per adjusted discharge were 34 percent higher for hospitals in investor-owned chains and 15 percent higher for freestanding investor-owned hospitals, said Coelen, who is also senior vice president of Abt Associates, a Cambridge, MA-based research and consulting firm.

Most studies of investor-owned and not-for-profit hospitals have concluded that their operating cost structures are "about the same," said Robert Derzon, a vice president of Lewing and Associates, a San Francisco-based consulting firm, and a member of the committee for the Institute of Medicine report. But Herzlinger's finding that hospital prices are similar "conflicts with every study that has been done. Rates have always been shown to be 5 percent to 25 percent higher (in investor-owned hospitals) per unit of service," he said.

As for Herzlinger's focus on the importance of social subsidies, "I wouldn't disagree that not-for-profits have special obligations to fulfill social responsibilities," Derzon said. But there's no good evidence that they're falling short of these obligations, he said.

Although he didn't contest Herzlinger's statistical findings, Arnold Relman, M.D., editor of *The New England Journal of Medicine* and an advocate of the values of not-for-profit health care, underscored her study's limitations at a recent conference in Cambridge. The study's exclusive focus on community hospitals means that it doesn't apply to the universe of not-for-profit hospitals, he said.

"The fact is the majority of beds in the not-for-profit sector are not in little hospitals located in clean, healthy, suburban communities," he said. Instead, the not-for-profit sector includes large, urban tertiary care centers that care for many indigent patients. With only a few exceptions, investor-owned chains have not chosen to own or operate these hospitals, he said.

Social subsidies for not-for-profit hospitals have resulted in "a system that is willing to face up to the real problems of healthcare," including indigent care and medical education, Relman said. Academic medical centers and other tertiary hospitals are performing a valuable social function by treating large numbers of indigent patients, he said.

Herzlinger did not analyze the amount of indigent care provided by not-for-profit and investor-owned hospitals because uncompensated care usually is measured as a deduction from charges. Hospital charges in the years she studied are "meaningless numbers" that do not reflect hospitals' actual costs, she said.

Replacement gap

William Cleverley, a professor at Ohio State University, said recent data reinforce concern about the age of hospitals' facilities and their ability to replace their plants. The average age of hospitals' facilities increased to 7.063 years in 1985 from 6.995 years in 1984 and 6.982 years in 1983, according to recently published data from the Financial Analysis Service of the Healthcare Financial Management Assn.

"Approximately 75 percent of U.S. hospitals have plants that are older than the manufacturing average (of 5.931 years)," Cleverley wrote in HFMA's Hospital Industry Analysis Report. "Hospitals are unwilling to replace and expand existing plants given the current situation of excess capacity. However, an aging plant can have negative implications for the future quality of hospital services."

Hospitals' underfunding of reserves needed to replace their facilities also is a source of concern. Cleverley said. Hospitals have relied heavily on debt financing for their replacement needs because their capital costs were fully reimbursed. But with increased competition, prospective rates, and proposed limits on capital cost reimbursement, hospitals probably won't be able to borrow as much.

The study's author says her findings apply to thousands of not-for-profit community hospitals as well

Assuming that hospitals will finance 50 percent of their replacement needs with equity and 50 percent with debt, the average hospital had in reserve in 1985 only 39.5 percent of the equity it would need for replacement purposes, compared with 34.7 percent in 1984 and 35.4 percent in 1983. Consequently, "the average hsopital would need to borrow approximately 80 percent of its replacement needs, (but) for many hospitals this may not be feasible in the future," Cleverley wrote. "To ensure their replacement viability, most hospitals should dramatically increase their levels of depreciation funding." ■

STATEMENT OF

GEORGE J. MERTZ, PRESIDENT

NATIONAL INDUSTRIES FOR THE BLIND

ON BEHALF OF

WORKSHOPS FOR THE BLIND

BEFORE THE

HOUSE OF REPRESENTATIVES

WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

JULY 17, 1987

A. INTRODUCTION:

National Industries for the Blind (NIB) is a private, section 501 (c) (3) nonprofit agency incorporated in the state of New York on August 10, 1938. Its purpose as stated in its Certificate of Incorporation is to promote the welfare of blind persons in general and blind workers in particular. Shortly after the passage of the original Wagner-O'Day (WOD) Act in 1938, NIB was designated by the Presidentially appointed Committee on Purchases of Blind-made Products as the Central Nonprofit Agency (CNA) to represent workshops for the blind participating in the WOD employment program. As the designated CNA, NIB works closely with the successor Committee for Purchase from the Blind and Other Severely Handicapped (CPBOSH) and federal procurement agencies in assisting sheltered workshops to provide increased employment opportunities for blind persons. Although this statement is being presented on behalf of NIB-associated workshops for the blind, it may be equally applicable to other sheltered workshops serving handicapped persons.

We applaud the Subcommittee's efforts to eliminate abuses by strengthening the Unrelated Business Income Tax (UBIT) law, its regulations, and implementation. After attending the hearings conducted by the Subcommittee, we believe that neither NIB nor the sheltered workshops are targets of the various changes proposed by small business advocates. We are, however, concerned that adoption of certain recommendations, such as those proposed by the Office of Advocacy, Small Business Administration (SBA), would have an unintended, yet devastating impact on blind and severely handicapped individuals served by the sheltered workshops.

B. BACKGROUND INFORMATION:

Of the estimated 900,000 nonprofit organizations in the United States, about 5,400 are sheltered workshops and only about 115 specialize in serving blind and multihandicapped blind persons. In addition to being a small segment of the nonprofit community, these organizations are unique and different from other nonprofits. Since the sheltered workshops and the work they perform is not generally well known, we are taking the liberty to describe it in some detail:

1. DISABLED PERSONS:

Disabled persons, like other Americans, do not form a homogeneous group with identical capabilities, needs, and requirements. To understand their employment potential, one must take into account factors such as their abilities and limitations (if any, imposed by the disabling condition) compared with job requirements, education, qualifications and training, accommodations and supportive services needed, job opportunities, attitudes of potential employers and coworkers, availability of affordable technology, job discrimination, and others.

For the sake of understanding employment potential, disabled persons can be divided into three broad categories with many individual exceptions. There are many disabled persons who possess at the most, only a limited handicap for the job under consideration and who are capable of obtaining and holding employment in private industry (after receiving necessary rehabilitation services) without any governmental or private assistance. They require only minimum job modifications and little or no supportive services to function in the competitive job market and to perform at normal levels of productivity. As a result, any added cost of employing them is limited. At the other extreme are disabled persons, some of whom are institutionalized, who, under the current circumstances, either simply cannot work or cannot be employed at the present time (based on currently available and affordable technology) in view of the severity of their disabling conditions and/or the extent and type of modifications and supportive services that would be needed to enable them to obtain and hold employment. The added cost of employing these persons is prohibitive and beyond the capability and/or willingness of industry and even beyond the capability of some workshops. In between these two groups are disabled persons who either cannot obtain and hold employment in the competitive labor market but who do have the ability to be employed in sheltered workshops on the basis of necessary job modifications and supportive services or who prefer sheltered employment. Within this group, even after such modifications, there are those that tend to have less productive capacities due to their disabling conditions. The added cost of employing them is beyond the ability or willingness of most competitive employers, but which the sheltered workshops are willing to undertake because serving such persons is their primary purpose.

Industry, including small businesses, is often willing and able to hire disabled persons from the first group since they require very minor or no job modifications and supportive services. Unfortunately, industry is either unwilling or unable to make the necessary job modifications or provide the needed supportive services to employ severely disabled persons. These statements are supported by a recent survey of disabled persons conducted by Louis Harris and Associates (study #854009: March 1986). Sheltered workshops, including those associated with NIB, are organized to serve those disabled persons not otherwise served by industry. In fact the Javits-Wagner-O'Day Act (JWOD), discussed below, generally limits its benefits to this group of individuals that are not being or cannot be served by government and industry.

Small business, which accounts for over 50 percent of the nation's employment, has created two-thirds of all new jobs in the nation according to a recent study. For this, they deserve credit. However, according to the Louis Harris survey referred to above, the unemployment rate for disabled persons is currently 66 percent in contrast to just over 6 percent for the general population. It is clear that neither small business, government, nor industry in general, has created sufficient employment opportunities for disabled persons either because of higher costs, needed job and tooling modifications, or supplemental services. This is where sheltered workshops come in and provide such employment opportunities because they are organized and equipped to take on the additional responsibilities of employing disabled persons who require supportive services.

2. SHELTERED WORKSHOPS:

Sheltered workshops that provide employment and related services to blind people in the United States were generally considered to have started with the first program in 1842 at the Perkins School for the Blind in Watertown, Massachusetts. Although the Perkins School was graduating blind young men, they were unable to find employment. Society at large, including industry, simply did not recognize that blind people could be productive citizens. In order to provide some type of reasonable employment and a measure of self-sufficiency, the Perkins School was forced to start its own employment program. The program was later expanded to provide jobs for other blind people in the greater Boston area who were not graduates of the Perkins School.

In the following decades, concerned citizens and other schools for the blind began to realize the almost totally unmet need of jobs for blind people. More workshops were, therefore, begun in major metropolitan areas. The primary mission of these workshop programs prior to 1938 was clear-cut: provide an opportunity for self-sufficiency through productive work, because no one else would. Much of the work done in these initial workshops involved simple handicraft items, chair caning, basket weaving, broom making, and needlework. Products were sold to the general public, commercial firms and government agencies, but most often on a sporadic basis. The result was intermittent employment followed by extended periods of inactivity for many blind people.

In 1938, at the urging of leading blind citizens and workshops for the blind, Congress passed the Wagner-O'Day Act (see below) with the purpose of providing a steady market for workshop products and, therefore, steady employment for blind persons.

As sheltered workshops grew, other unmet needs of blind people were recognized. Additional services related to independent living were developed so that some blind persons would not remain a burden on their families or community. As more services were added, workshops evolved into multi-service organizations which could address the needs of the whole person.

Increased efforts were made to open competitive sector jobs for blind people through demonstrating their capabilities to industry and society alike. This involved constantly searching for more complex products requiring market relevant skills which could be adopted for manufacture by blind persons. As a result of these efforts, and increasing acceptance by industry, more and more blind people were able to obtain competitive employment, thereby freeing workshops to concentrate on those multihandicapped blind persons who were previously considered to be unemployable. As a result, the proportion of multihandicapped blind persons employed by the workshops has increased steadily from 9 percent in 1968 to almost 50 percent in 1986 with mental retardation and severe hearing loss as the most prevalent secondary disabilities.

Sheltered workshops serve a social function by catering to the most severely handicapped, a priority repeatedly urged by Congress itself. In order to employ the targeted group of handicapped persons, sheltered workshops must necessarily provide a wide range of habilitation, rehabilitation, training, accommodations, placement and supportive services. Some of the services provided and special accommodations made by sheltered workshops are:

* Pre-vocational and vocational evaluation
* Orientation, mobility and independent living training
* Flexible hours and part-time employment
* Transportation
* Psychological counseling
* Work adjustment
* Extended training programs, on-the-job training
* Matching jobs to individuals

- Rehabilitation engineering
- Job modifications such as breaking it down into simpler components
- Special jigs and fixtures
- Redesigning workplace/appropriate light and color
- Special work stations
- Modifying equipment and tooling
- Provision of additional equipment, tooling, and supervision to account for less than 100 percent productivity
- Upward mobility to indirect labor, and supervisory or management positions
- Competitive placement services

3. JAVITS-WAGNER-O'DAY ACT:

The original Wagner-O'Day Act (WOD) was signed into law by President Roosevelt on June 25, 1938. It was designed to create additional employment opportunities for blind persons by requiring the government purchase of selected commodities produced by workshops for the blind. Participation in the Act was limited to nonprofit agencies employing at least 75 percent legally blind direct labor hours in the production of commodities. The WOD Act was amended in 1971 as the JWOD Act to permit participation by workshops serving the other severely handicapped and included services for the first time, in an effort to further expand employment opportunities. The term severely handicapped was defined in the Act itself as "persons under a physical or mental disability, which constitutes a substantial handicap to employment and is of such a nature as to prevent the individual from currently engaging in normal competitive employment". Once again, participation in the Act was limited to nonprofit agencies employing at least 75 percent legally blind or other severely handicapped direct labor hours. Thus the government program was designed for and limited to the targeted group of blind and severely handicapped persons most in need of such assistance.

4. SHELTERED WORKSHOPS - SOURCES OF REVENUE:

The 5,400 sheltered workshops in the United States serving over 260,000 blind and handicapped workers depend upon a variety of revenue sources, including most of those listed in Internal Revenue Service (IRS) Form 990, Part I. However, the proportion of each sheltered workshops' gross income from each of these sources varies widely. Some sheltered workshops endeavor to generate, as a matter of policy, most of their income from the sale of goods and services produced by handicapped workers, in keeping with the spirit of self-help for which they were created. A few are legally prevented from raising funds by state statute or by their charter or bylaws. Others are able to supplement their income, derived from selling goods and services, through fund-raising activities, either on their own or through community organizations such as the United Way. Some have significant endowment income while others have little or none.

The 81 agencies for the blind currently associated with NIB representing 105 sheltered workshops are operated by Boards of Directors or other governing bodies. There is a wide variation in sources of gross revenue among the agencies for the blind, particularly since some of them are "full service rehabilitation agencies", while others are primarily sheltered workshops. In many cases, private and public charitable giving has provided the base for the parent agency service programs, whereas the workshops have relied primarily on the sale of goods and services resulting from the employment of blind workers.

It is important to note that this is another factor that makes sheltered workshops unique. Statistics presented to this Subcommittee have indicated that nonprofits, over the years, have relied increasingly upon the sale of goods and services and less and less upon donations. However, the revenue sources for sheltered workshops have generally remained unchanged over at least the past 48 years since the original WOD Act was passed.

The net income (if any) that sheltered workshops receive from the sale of goods and services is considerably less than that of for-profit businesses engaged in similar activities because their costs of production are appreciably higher. Thus often losses occur which must be made up by donations. Where a net margin is realized, it, of course, cannot be utilized for the benefit of any individual and is commonly used for providing additional services to blind and severely handicapped persons.

5. FEDERAL GOVERNMENT INVOLVEMENT:

Reaching back over at least a half century, the federal government has had a commitment to creating and promoting employment opportunities for handicapped persons. Various laws have been enacted and regulations adopted to ensure that handicapped workers are given a chance to participate in the economic life of the nation. Examples of this effort are many. The Randolph Sheppard Act of 1936 created opportunities for blind persons to operate vending stands on federal property. The Fair Labor Standards Act (FLSA) of 1936 adopted special minimum wage provisions for handicapped persons in order to prevent the loss of employment opportunities as a result of impaired productivity. In addition, the FLSA also encouraged the creation of Work Activities Centers for employing handicapped workers whose productivity was "inconsequential". The JWOD program, originally enacted in 1938, is an excellent example of the federal government encouraging the employment of blind and severely handicapped persons within sheltered workshops through the purchase of goods and services produced by such persons. The Rehabilitation Act (specifically sections 503 and 504) prohibits discrimination in hiring, promotions, etc. on the basis of a person's disability. Qualified businesses hiring handicapped workers are encouraged and given tax benefits, although this has not produced the desired results.

C. ISSUES:

1. UNRELATED BUSINESS INCOME:

As indicated above, the primary purpose of the sheltered workshops is to provide a range of habilitation, rehabilitation, training, employment and placement services to the targeted group of blind and severely handicapped persons. The sheltered workshops must necessarily provide such services because neither the government nor industry is able and/or willing to do so in the quality and quantity desired. Workshops achieve their objective primarily through the creation of market relevant jobs which also serve to train blind and handicapped persons in marketable skills and improve their chances for placement in competitive industry. We believe that the production of goods and services by sheltered workshops is so fundamental to the existence of their exempt purpose as to be a mere extension of it, capable of standing alone to fulfill that exempt purpose, and thus, any income derived from the sale of such goods and services is clearly "related" income under the UBIT statute.

It is important to appreciate why sheltered workshops produce and sell goods and services which are also provided by for-profit firms. Would we have blind and handicapped persons do nothing more than simple handicraft or "make-work" jobs or depend upon public charity rather than become self-sufficient, taxpaying citizens? Since the original Wagner-O'Day Act was enacted in 1938, NIB, along with the sheltered workshops, has been instrumental in changing the perceptions of government, industry, and society regarding blind workers by developing meaningful jobs with higher skill requirements by selecting and adopting complex products for manufacture by blind workers. Blind persons are no different from other Americans. Their concept of self worth is closely connected with their jobs and how these are viewed by society. By performing market relevant jobs, blind and multihandicapped blind persons not only enhance their self image, they also earn decent wages and fringe benefits, become taxpaying citizens and learn skills that improve their chances for upward mobility and competitive placement.

2. UNFAIR COMPETITION:

NIB believes that while sheltered workshops may compete with small businesses in a limited sense, they do not compete unfairly. The goal of small businesses is maximizing profits, whereas for sheltered workshops it is increasing employment and related services for handicapped persons. Therefore, they do not vie for a common "prize" and thus cannot be said to "compete" directly with each other. In fact, NIB would like to see increased competition between for-profit businesses and sheltered workshops in the hiring of blind and handicapped workers.

Because of their defined mission and the people they serve, sheltered workshops deliberately limit their ability to compete with industry. For example:

* At a time when most industry is improving productivity through automation, sheltered workshops find it difficult to automate because it could mean a reduction in handicapped employment.
* Unlike industry, sheltered workshops do not export jobs abroad to take advantage of cheap labor or move to another community to take advantage of market conditions, availability of workers, lower wages, or tax benefits. They must remain where their handicapped workers reside.
* Sheltered workshops have limited capital resources and access to both government and commercial loan sources.
* Sheltered workshops cannot attract the top-notch graduates from business schools and colleges and universities because of modest salaries and limited opportunities.
* Sheltered workshops must develop specially designed work stations and equipment.
* There is a need for additional job training, rehabilitation and supportive services in sheltered workshops.

The Fair Labor Standards Act (FLSA) Section 14 (c) which applies to both sheltered workshops and to businesses, permits payment of less than minimum wages to disabled persons in order to prevent curtailment of employment opportunities. The workers must still be paid wages commensurate to those being paid non-handicapped persons for essentially the same quality and quantity of work. This means that for an identical method used, the per-piece rate is the same for handicapped as well as the non-handicapped person. However, beyond the wages themselves, the employer serving blind and handicapped individuals must make necessary modifications to the job and workplace, provide additional equipment, tooling, and supervision to account for those unable to achieve 100 percent productivity and provide the necessary support services previously described. Therefore, the total cost of wages, fringe benefits, and supportive services furnished for every piece produced are significantly higher than those for non-handicapped workers. If this were not true, commercial industry would be rushing to hire this group of handicapped persons to benefit from the supposedly lower costs of production. Although sheltered workshops are willing to accept such higher cost based on their mission, they would be happy to relinquish it, if it results in competitive employment for blind and handicapped persons.

Some advantages possessed by small businesses are difficult to quantify. For example, what are the intrinsic advantages of working with a productive, non-handicapped work force that does not require a great deal of adjustment, training, accommodations, supportive services, etc.? It could also be argued that federal statutes give special advantages to small business not enjoyed by sheltered workshops. The Small Business Act provides a set-aside in government contracts; sheltered workshop federal contracts are even less than one percent of the total of those received by small business. And we wish to point out that NIB has opposed proposals to give sheltered workshops a similar set-aside -- we are willing to make it on an even playing field. Sheltered workshops do not receive the technical assistance, opportunities for guaranteed loans, and the entire range of services provided by the Small Business Administration to benefit small business.

Several studies by impartial government agencies and others have demonstrated that sheltered workshops do not enjoy a competitive advantage over small businesses. Prompted by complaints from a few small businesses, the General Accounting Office (GAO) conducted a detailed study (HRD 81-99, dated September 1981) of sheltered workshops and any competitive advantage they might possess. The GAO found no proof of competitive advantage for sheltered workshops. Similarly, continuing oversight of sheltered workshops participating in the JWOD program by Congressional Committees has never raised the issue of unfair competition with industry. In fact, Congress has recommended that more federal agencies and Congress itself should be buying under the JWOD program. Finally, a 1986 study by the Santa Fe Corporation, an independent consulting firm, found that the competitive advantage, if any, really belonged to small businesses and not to sheltered workshops.

3. COMMERCIAL ACTIVITIES:

SBA has suggested establishing a ceiling on so-called "commercial" activities of nonprofits. Others have suggested that nonprofit organizations should not engage in "commercial" activities that are also provided by one or more for-profit businesses. The definition of "commercial" activities adopted by small businesses appears to include any activity that has a value in the marketplace and, as such, is either currently performed by for-profit businesses or could be performed by them in the future. Under this definition, any manufacturing or service activity by a sheltered workshop would automatically be considered a "commercial" activity.

There are fundamental problems with this definition because it ignores the purpose for which the alleged "commercial" activity is carried out and the manner in which it is carried out. In our opinion, true "commercial" activities have a fundamental goal of maximizing profits and as such, are carried out in order to either reduce costs or maximize profitability.

There are significant differences between for-profit businesses and sheltered workshops. Businesses select the product to be manufactured on the basis of market research to ensure high profit margin, low competition, and high demand. The manufacturing process and equipment are chosen on the basis of lowest production costs while meeting quality and delivery requirements. In some cases, this could mean total automation of the manufacturing process resulting in the elimination of most labor, or even producing the item abroad. The company then attempts to hire the most productive workers it can find at the lowest wage rate. Such highly productive workers are retained while the unproductive workers are either not hired or terminated at the earliest opportunity. After the start of production, the business is constantly on the look-out for further cost savings through redesign of the product, changes in the process and equipment, and other actions. If necessary, the production of that item is discontinued to concentrate on a more profitable item or the manufacturing process shifted to a foreign country to reduce labor costs.

In contrast, a typical workshop for the blind associated with NIB selects a product for manufacture under the JWOD Act with the primary goal of maximizing the employment potential for blind persons. Any products lacking adequate employment potential are considered to be unsuitable for production under the JWOD program. Equipment and processes are selected in order to increase the available labor hours. Moreover, workers are generally employed on the basis of their lack of capability to engage in or locate competitive employment. Typically, many such workers require substantial training, accommodations, and supportive services to improve their productivity, which is one reason they have not been hired by the for-profit businesses. NIB even encourages its associated workshops to open up Work Activities Centers in order to hire multihandicapped blind workers whose productivity is "inconsequential". The jobs, equipment, and tooling are all modified to match the workers' abilities and limitations and training and necessary supportive services are provided to permit them to continue to work. In addition, every effort is made to promote upward mobility or to place the most productive workers outside the sheltered workshop in competitive industry so that the workshops can redirect themselves to serving others with lower productivity. It is clear from this that sheltered workshops produce and sell goods and provide services primarily for the purpose of creating employment and not for maximizing profits. Their specific decisions regarding product and equipment selection, the hiring and promotions of workers and others are consistent with their mission and actually increase production costs rather than maximize profits. In fact, it can be argued that if the workshops' goal is to engage in "commercial" activities, they are going about it the wrong way.

Finally, we are pleased to emphasize that such "commercial" activities of sheltered workshops have been repeatedly encouraged and promoted by federal and state governments through a variety of laws and regulations.

4. EARNED INCOME CEILING:

One of the recommendations by SBA and certain small business advocates is to limit the income from "commercial" activities that nonprofits would be permitted to earn before their tax exemption is revoked. As stated above, sheltered workshops in general, and those associated with NIB in particular, depend on the production and sale of goods and services in order to fulfill their basic mission of providing habilitation, rehabilitation, training, employment, placement and supportive services to the handicapped persons they serve. A ceiling on earned income will force sheltered workshops to curtail such activities and depend more on fund-raising activities. Such dependence on charity is contrary to the spirit of self-help that sheltered workshops have adopted and are trying to instill in the handicapped persons they serve. NIB believes that any restrictions on self-generated income will simply penalize those handicapped workers who prefer to be self-reliant and reward those who depend on charity.

D. POLICY CONSIDERATIONS:

The Subcommittee is properly concerned with the basic question of tax policy as it applies to nonprofit organizations. The purpose of granting tax exemption has always been to encourage certain activities that are considered to be of great interest and usefulness to the nation and society. The key question that the Subcommittee must ask is, "Is government and private industry capable of adequately providing the services currently provided to blind and handicapped persons by sheltered workshops?"

NIB believes that promoting the employment of the targeted group of blind and handicapped persons and providing them with needed habilitation, rehabilitation, training, placement and supportive services is certainly a purpose that deserves the encouragement of Congress through tax exemption. Since industry is still unable to provide adequate employment services for handicapped persons (as clearly indicated by an unemployment rate of 66 percent), in spite of the special tax advantages offered for hiring such persons, NIB strongly urges Congress to retain this tax exemption for the foreseeable future. If, in the distant future, this exempt purpose no longer appears to be in the national interest, or if government and industry emerges to provide needed services to all blind and handicapped persons in adequate quality and quantity, then Congress should certainly, at that time, consider withdrawing tax exemption. As stated above, the federal government has had a long-term, ongoing commitment to creating and promoting employment opportunities for blind and handicapped persons. If the Subcommittee were to reverse this by restricting the production and sale of goods and services by sheltered workshops, Congress will be sending contradictory signals to handicapped persons and to the nation. While encouraging handicapped persons to become self-sufficient, taxpaying citizens through programs such as JWOD, the government will be curtailing their employment opportunities by making sheltered workshops rely more on charity and less on their employment-generating activities.

In a sense, this entire debate is about "opportunity" and "fairness". The small businessman seeks nothing but an "opportunity" to compete fairly and to make profits. He is willing and able to devote himself, take chances, build his business through hard work and long hours. NIB salutes the small businessman and we wish him well. Congress should ensure that he is given that opportunity. On the other hand, the blind and handicapped workers served by the sheltered workshop, seek nothing but an "opportunity" for a meaningful job, an opportunity currently denied to them by industry. They are willing and able to devote themselves and prove to themselves and others that they can be self-supporting, taxpaying citizens. We believe Congress should do no less for them.

E. RECOMMENDATIONS:

1. NIB supports all of the "initial observations and recommendations" made by the Department of Treasury as shown on pages 3 and 4 of Mr. Chapoton's statement.

2. NIB believes that the current UBIT laws and regulations are reasonable but should be better-enforced to eliminate abuses. Congress can improve IRS enforcement by clarifying some of the ambiguous terms. However, like the Treasury Department, NIB believes that the relatedness standard is a valid test and must be retained. IRS should provide clear guidance to reduce unintentional non-compliance with the law.

3. NIB strongly disagrees with the suggestion by SBA and certain small business advocates that a ceiling on "commercial" activities of nonprofit organizations be adopted, since this will prevent sheltered workshops from performing their basic mission.

4. In its deliberations, we urge the Subcommittee to keep in mind the unique role of sheltered workshops in providing gainful employment to the targeted group of blind and severely handicapped individuals, some of whom otherwise may remain idle and dependent on public funds or their families or remain institutionalized. The golden mean of charity is not the bestowing of alms but helping someone to help himself. This makes not only for good philosophy but good government and good business.

5. The commitment of federal government to creating and promoting employment of blind and handicapped persons is well established. We urge a stepped-up effort with built-in incentives for industry to employ the handicapped in rough proportion to their numbers in the working age population.

6. Regardless of any decision about a ceiling on the "commercial activities" of nonprofit organizations, NIB strongly urges the Subcommittee to exempt all nonprofit organizations participating in the JWOD program along with all other sheltered workshops so that they can continue to provide employment services to blind and severely handicapped persons.

Statement of: **National Office Products Association**

Before the: **Subcommittee on Oversight**
Committee on Ways and Means
Review of the Unrelated Business Income Tax

Mr. Chairman, Members of the Subcommittee:

My name is Donald P. Haspel and I am Executive Vice President of the National Office Products Association. NOPA is an industry-wide trade association representing 8,000 corporations engaged in the manufacturing, retailing and wholesaling of office supplies, furniture, computers and software. I welcome the opportunity to submit these comments in conjunction with the Subcommittee's hearings on the subject of the unrelated business income tax.

We want to add to the hearings before the Subcommittee our comments regarding the extent to which tax-exempt, nonprofit organizations are competing with for-profit businesses in the office products industry. It is a problem that dates to the early 1960s for the office products industry, but in recent years both the extent and scope of the problem have become more acute.

Of particular concern is the competition computer retailers face from on-campus college and university sales of personal computers and software. Office furniture dealers and manufacturers face highly aggressive furniture marketing programs conducted by both federal and state prison and correctional facilities.

The competition NOPA members face from the nonprofit sources is highly unfair. Commercial nonprofits bring with them the special privileges they enjoy in being tax-exempt. These advantages such as exemption from income, sales and property taxes, much lower postal rates, and in the case of universities, an aura of prestige in the community, or in the case of prison industries, an aura of rehabilitation, create distinct business advantages over their for-profit, taxpaying competitors. In each case, small businesses in the office products industry are being taxed to subsidize their competitors.

Consequences of such unfair competition are far-reaching. Retailers provide much needed service and support of their products. In the case of computer products, significant technical support and training are often necessary. When nonprofits sell computer equipment, the customer loses these necessary support services. In many cases, retailers not only suffer the loss of the sale, but also incur the expense of supporting university customers who lack the technical skills to operate and maintain their newly-purchased equipment.

Another severe consequence of sales by commercial nonprofits is price erosion. In the computer industry particularly, computer manufacturers compete aggressively to place their systems in educational institutions. This practice helps vendors cultivate the allegiance of future executives who will recommend their equipment.

As vendors vie for presence in the classroom, they offer discounts to educational institutions which are not made available to computer retailers. Thus their nonprofit status makes it possible for educational institutions to enjoy special pricing not offered to taxpaying retailers.

As colleges and universities market and resell the equipment, their preferential treatment is reflected in their pricing. Consumers form price expectations which become fixed at an artificially low level, and the price structure of the equipment erodes. Subsequent customer purchases are affected by the nonprofit pricing, and dealer profitability declines still further.

It should be noted that manufacturers trapped in the university selling cycle also suffer. By sacrificing profits for presence in educational institutions, pricing erodes and manufacturer profits decline. Dealers drop manufacturers' lines because they are no longer profitable, and a vicious cycle develops. Customers expect lower pricing, dealers cannot carry products that are not profitable and cannot support products they don't carry.

Vendors face a triple loss: loss of profits, loss of dealer base, and loss of customer support. Customer satisfaction declines as frustrated customers blame the manufacturer and become dissatisfied with the equipment. The manufacturer's reputation and market presence suffer. Ultimately, capital for research and development dwindles, and the competitive strength of the U.S. manufacturer is weakened.

Prison industry programs present different problems but the pattern of abuse inherent to nonprofit competition remains similar.

PRIDE (Prison Rehabilitative Industries and Diversified Enterprises) is a nonprofit corporation in Florida intended to put state prisoners to work toward their rehabilitation. It operates as a mandatory source of supply for product on state contracts; permitting every county, every municipality and every school board to purchase product on that contract. Similar programs exist in many other states and at the federal level.

The aim is laudable, but for every furniture dealer or manufacturer who would like to sell to the government or any other local entity, that company is up against a nonprofit corporation which in addition to being a mandatory source of supply, pays no taxes; remits none; does not have to pay unemployment or workers' compensation insurance; offers no fringe benefits; pays its labor, in some instances, less than $1 per hour; and has free buildings in which to operate.

At a time when economic concerns are paramount in the national consciousness, it is essential to reexamine our need for a strong and healthy taxpaying private sector. Valid reasons justify the existence of tax-exempt nonprofit organizations. But the laudable goals of nonprofits do not justify the unexamined, uncontrolled growth of commercial activities by nonprofit entities.

NOPA does not contend that nonprofits should be excluded from the marketplace. But it does insist that fairness requires them to compete on equal terms with other businesses. Federal and state subsidies of nonprofit commercial activities should cease.

The problem and the principle NOPA espouses were recognized by the U.S. Congress as far back as 1951. In that year, Congress instituted the unrelated business income tax to apply to revenues realized by nonprofits from activities not directly related to their tax-exempt purpose. The expressed intent of Congress was to eliminate unfair competition between tax-exempt and taxpaying firms. The intent of these reforms must be respected and enforced.

June 1987

STATEMENT
OF
JOHN PAUL GALLES
EXECUTIVE VICE PRESIDENT
NATIONAL SMALL BUSINESS UNITED
ON THE ISSUE OF
UNRELATED BUSINESS INCOME TAX
PREPARED FOR THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT

Mr. Chairman: National Small Business United (NSBU) is pleased to submit this statement for the record concerning the unrelated business income tax. We appreciate your willingness to obtain the input of the small business community. NSBU is a new, national, small business trade association formed from the merger last year of the National Small Business Association, a multi-industry small business trade association founded in 1937, with Small Business United, a coalition of regional, state, and metropolitan small business associations organized in 1981 after the first White House Conference on Small Business. NSBU represents over 50,000 small businesses nationwide.

Unfair competition from the public sector was the number three priority of the small business delegates attending the most recent White House Conference on Small Business held here in Washington this past August. This issue is of crucial importance to our members, too. They believe that government organizations and non-profit, tax-exempt entities should be prohibited from using their government-bestowed, special status to compete unfairly with small business. NSBU commends you for holding these hearings and we encourage you--and perhaps your colleagues in the other body--to further investigate the tax-exempt status of non-profit organizations in order to separate purely profit-making activities for tax purposes.

NSBU recommends that at the federal, state, and local levels, any laws, regulations, and policies should:

-Prohibit unfair competition in which non-profit, tax-exempt organizations use their tax-exempt status, procurement, and other advantages in selling products and services also offered by small business, and

-Prohibit direct, government-created competition in which government organizations perform commercial services.

NSBU takes this position because, increasingly, we see the government competing with entrepreneurs in providing commercial goods and services through in-house staff or government-favored non-profit organizations, universities, and regulated industries. Organizations--which should be devoted to public policy formulation, education, and basic research--are diverting important resources to commercial activities--all at the taxpayer's expense.

The magnitude of this problem is not well understood, even by those most directly affected. Small business does, however, understand tax burdens which are arbitrary because they immediately affect the pocketbook. It also understand when opportunities are lost--when revenues are never earned--because of competition from non-profit entities.

Government-produced goods and services translate into lost income for small businesses. Lost income means lost tax revenues, from both the business itself and from the employees the business would have hired to perform the additional work that a Federal contract would bring.

OMB Circular A-76 sets forth the policy, established in 1955, that the government should not compete with the private sector and, whenever feasible and cost-effective, goods and services should be acquired from the private sector. Under OMB Circular A-76, agencies are supposed to review, every five years, jobs that are not inherently governmental to see if the private sector could perform the work for less money. According to an August 1986 report by the SBA: "Ineffective implementation of this policy, as well as legislative restrictions or prohibitions on contracting-out, have resulted in an estimated $20 billion of activities being performed by the government which could have been performed by the private sector."

An SBA Task Force report documented that in several traditional lines of business, such as travel agents, hearing aid dealers, and in expanding new areas of the economy--such as research and development, analytic testing, and educational software, there is very real and significant participation by non-profits in essentially commercial activities.

In addition, non-profit organizations, as "grantees" of various federal agencies, receive various types of education and scientific equipment. When this equipment is converted to commercial endeavors, these non-profits enjoy a cost and overhead advantage over the private small firm that has purchased and financed the equipment on its own. In 1982, the National Science Foundation (NSF) recognized this problem and imposed regulations upon the use of such equipment funded through NSF grants.

Unlike the private sector, electric and gas utilities are entitled by law to charge prices that will earn profits on their investments. These regulated industries are increasingly becoming involved in providing energy-related services which are currently available for small businesses operating in open, competitive markets.

Government at all levels should not compete with the private sector or conduct any activity which may be available from the taxpaying private sector; nor should it compete indirectly by providing preferences, such as tax exemptions, postal privileges, contracting priorities, or other special benefits, to the commercial, competitive activities of non-profit or regulated industries. These preferences allow such entities to compete unfairly with small business.

NSBU believes that if these special preferences were given closer examination, Congress would see the need to re-evaluate them in the best interest of all taxpayers. If this were done, small business would be in the best position to increase the tax base, create more jobs, encourage innovation, and enhance productivity.

Again, Mr. Chairman, on behalf of NSBU's more than 50,000 members nationwide, NSBU appreciates this opportunity to share its views with you and the Committee.

NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS

NSPE

July 10, 1987

Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
House Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Pickle:

We appreciate this opportunity to discuss the issue of the taxation of unrelated business income in the case of not-for-profit trade associations and professional societies.

NSPE applauds the Subcommittee's efforts to clarify the issue of taxation of unrelated business income generated by not-for-profit associations and professional societies. It is clear that there has been a good deal of confusion as to the nature, extent, and applicability of the unrelated business income tax. Hopefully, the work of the Subcommittee will result in a clarification of these issues.

The National Society of Professional Engineers (NSPE) is a nationwide professional society founded in 1934. It represents over 75,000 engineers in the United States and abroad. NSPE members are also members of one of the 54 state and territorial societies, as well as one of the 535 local chapters.

The goals of NSPE are set forth in Article II of the NSPE Constitution. That Article states: "The objectives of the National Society shall be the advancement of the public welfare and the promotion of the professional, social and economic interests of the engineering profession; to stimulate and develop professional concepts among all engineers; and to strive throughout the profession to make registration more meaningful in terms of acknowledgement of individual achievement as reflected by education and practice, and to urge each engineer to seek legal status through registration at the earliest possible point in his career."

NSPE strives to achieve these goals through many programs and professional activities at the local, state,

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and national levels. NSPE members contribute their technical knowhow in providing information to lawmakers and policy makers on complex public policy issues. Such technical input helps insure sound public policy decisions in a technological world.

NSPE has played a significant role in improving America's competitive position through its program to improve the math skills of our seventh and eighth graders. That program is called MATHCOUNTS, and now involves over one million American youngsters in some 8-10,000 schools throughout the country and abroad. NSPE supports the largest engineering scholarship program of its kind in the country, with over $1,000,000 in grants and scholarships awarded in 1986 and is also embarking upon related pre-college guidance, continuing professional development and student programs. These programs are made possible through the donated talents of NSPE engineers and the voluntary dues paid by those members.

NSPE serves its members and the nation through its effort to place in high esteem professionalism and ethical principles. NSPE has a very strict Code of Ethics, which is interpreted by a Board of Ethical Review and enforced through its affiliated state societies. NSPE sponsors National Engineers Week to help call public attention to contributions made by engineers and engineering to the quality of American life.

These activities are supported by NSPE members who pay dues ranging from $50 to $100, depending upon the age of the member. Dues from individual members of NSPE constitute approximately 71% of NSPE's income.

Associations and professional societies have been exempted from taxation because of the benefits their programs offer our society. The activities of NSPE set forth above amply demonstrate that those benefits are being provided by NSPE. Other tax exempt organizations are providing comparable benefits. There are undoubtedly instances of abuse. NSPE supports the strict enforcement of the provisions regarding unrelated business income. We would note, however, that many of the cases of non-compliance may be attributable to the confusion which exists on this issue. Confusing interpretations and instructions have been issued by the Internal Revenue Service, and some groups have pushed their interpretation of just what is "related business income" beyond reasonable bounds. The deliberations of the Advisory Group recently formed by IRS should result in clarifications which will benefit all concerned.

In summary, NSPE feels that provisions of the Internal Revenue Code as they apply to the issue of unrelated business income are proper and should be enforced consistently. The Subcommittee and the Congress should carefully consider any proposed changes, lest the nation lose demonstrated benefits provided to society by voluntary associations and professional societies.

We appreciate this opportunity to comment on the issue of taxation of unrelated business income, and would be happy to provide the Subcommittee with additional information.

Sincerely,

Donald G. Weinert

Donald G. Weinert, P.E.
Executive Director

DGW/cc

NEW JERSEY GUILD OF HEARING AID DISPENSERS

NEW JERSEY GUILD OF HEARING AID DISPENSERS

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COMMITTEE ON
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WAYS AND MEANS

July 14, 1987

Robert J. Leonard
Chief Counsel
Ways and Means Committee
U.S. House of Representatives
Longworth House Office Building
Room 1102
Washington, D.C. 20515

Re: Unfair Competition - Non-Profit -
Tax Subsidized Institutions

Dear Mr. Leonard:

The New Jersey Guild of Hearing Aid Dispensers welcomes this opportunity to contribute to your inquiry. The need for legislation to correct long-term abuses by tax-exempt and tax abusive subsidized entities which are selling hearing aids and unfairly competing with the private, taxpaying small businessman is long overdue. What follows in this letter is simply a summary of the manner in which unchecked non-profit competition has impacted upon the affairs of some members of our Association.

The New Jersey Guild has a 26 year history representing small businessmen who are hearing aid dispensers throughout the State of New Jersey.

Every dispenser of hearing aids in the State of New Jersey is required to undergo a licensing procedure. The typical dispenser in New Jersey is a businessman who has not only invested the time to train and learn for his licensure but has also made capital investments in his office and the instrumentation and equipment necessary to test, fit and repair his product. Finally, as in most small businesses, the typical dispenser has invested also in the office staff, utilities and other overhead costs, all of which must be satisfied by the income that the dispenser derives from the patients he is able to attract to his practice.

The purpose of offering you this profile of the typical dispenser is not to show him in any worse light than any other private entrepreneur. All small businessmen are expected to have capital investments and overhead to meet before they realize any expendable income. The profile serves only to remind us of the reasons why competition by so-called "non-profit" entities is fundamentally unfair.

In New Jersey, as in all other states, hearing aid dispensers are finding it more and more difficult to retain patients and to attract new patients when, within their geographical service area, an institution such as a hospital or a college offers dispensing services to the general public. As is shown by the following examples, non-profit and tax-subsidized institutions are actually, presently, engaged in providing precisely the same kind of dispensing services offered by the private dispenser, but without the need to recover such capital costs as are implicit in the operation of the private dispenser's business.

In one central New Jersey community, one member of the New Jersey Guild has seen his long-established business rapidly eroded in the following manner: a local hospital operated on a non-profit basis began to offer hearing aid dispensing services through a hearing clinic which was set up within the hospital plant. Our investigation revealed that the same doctors who comprised the leadership of the hospital corporation were dually involved in the separate entity, believed to be a for-profit corporation, which "leases" clinic space within the hospital building. In this fashion, without any further activity on the part of these physicians, it was clear to the Guild that the hearing clinic would be the likely source of hearing aid dispensing services for any patient normally entering the hospital for general health care purposes. The Guild has not as yet expended its resources on developing evidence of actual "steering" from the general health care population into the hearing clinic; common sense supports the probability of steering. However, a more dramatic impact by this organization upon the local dispenser was caused by the subsequent acquisition by this same group of a local nursing home. Immediately upon taking charge of the affairs of the local nursing home, our member began to experience direct diversion of patients to the hospital-based clinic. The inability of the taxpaying dispenser to gain or retain a reasonable share of the available clientele within the same community is easily and painfully understandable by anyone familiar with basic economics.

In the northern part of our state, another member of the Guild reports the following example of institutional abuses: a patient of his recently reported that he had been attracted to the area hospital by reason of its offer of the dispensing services only to find out that after the testing was performed at the hospital's hearing center, he was asked to make out two checks in separate payment for the clinic services and a second check made payable to the private dispensing clinic owned and operated by the director of the hospital's clinic.

Finally, the most direct example of an inequity borne of governmental competition comes from the state college. This semi-autonomous agency of the state government operates a hearing center wherein patients are attracted from the community on the basis of the availability of low-cost testing procedures in an institutional setting. The Speech and Hearing Department is supervised by an audiologist who is also licensed as a dispenser of hearing aids. Without any pretense or apology, the state college actually engages in the direct sale of hearing aids to persons in the community who wish to avail themselves of that service.

When the dispensers in the college area approached the college Dean and sought the immediate cessation of such direct and unfair competition, the Dean responded by claiming that such activities were a requirement in order to attain accreditation from the national association. As we have determined from contacting that organization and has been clearly established in the State of Arizona where such practices are prohibited, actual dispensing by a college in direct competition with taxpaying dispensers cannot be excused on the basis of meeting accreditation. Hands-on experience can obviously be attained by any institution wishing to teach audiology or hearing aid dispensing by simply adopting an apprenticeship program involving practicioners in this field.

While some states such as Arizona have begun to rectify individual examples of abuse, we strongly believe the time has come for national rules, regulations and laws which will restore balance to basic economic competition uniformly in all parts of the United States. We therefore, value the work of your Committee and offer our complete assistance in providing you with the approriate information if the same will lead to an eradication of these most unhealthy economic circumstances which, to those who have felt the direct impact, is nothing short of economic piracy. We applaud the efforts of Representative Pickle and his fine Committee.

Very truly yours,

J.D. Fishman, President
New Jersey Guild of
Hearing Aid Dispensers

Novak Hearing Center

June 18, 1987

Robert J. Leonard, Chief Counsel
Ways and Means Committee
U.S. House of Representatives
Longsworth House Office Building Rm.1102
Washington, D.C. 20515

Dear Mr. Leonard;

I was encouraged to learn that hearings were planned for June 22, 1987 concerning tax - exempt (non-profit) commercial activities and enterprises. These proceedings are long over due and sorely needed.

As a businessman who has been and continues to be directly disadvantaged since 1983, I can most assuredly attest to the unfair advantages enjoyed by my so called non-profit competitor, Speech and Hearing Center. The Central Florida Speech and Hearing Center is located on city owned property, rent/free. This "Commercial Charity" uses all manner of advertisement to advance their cause including the efforts of The United Way to which they are affiliated. They enjoy public service promotions through the local newspaper, and radio stations. Additionally they exploit the so called "Halo effect" in that the public perceives them a health care providers motivated by altruism not greed or profit.

Since 1983 I have received absolutely no referrals where prior to 1983 when they DID NOT sell or service hearing aids, I averaged 45 clients per year. At that time the center's referrals constituted about 25% of my sales volume.

For this or any other non-profit 501,c,3 charity to sell anything, be it services or products, in direct competition with for-profit commercial business is clearly not what the original tax code provided for.

In essence these commercial charities are virtually modern day Robin Hoods, differing in that they don't actually steal from their clients for services or products sold, they reroute community citizens from for-profit businesses to their own enterprises, by implying that they are better equipped or trained to provide these services or products because they are a non-profit agency, contributes to the 'Halo effect' commonly cited as an unfair advantage.

953 East Memorial Boulevard • Searstown Shopping Center • Lakeland, Florida 33801 • (813) 688-2919

Passing tax code changes requiring non-profit to pay tax on profit from the sale of hardware or services is not going to correct the problem. Non-profits will simply divert excess receipts to capital improvement funds, increased pay rolls and a nepotism type continuation of local control through the efforts of well placed socially prominent community leaders whose desires can be fulfilled, through promoting their altruistic favorite charity.

Charity is basically an act of love and should be provided as such. Selling hearing aids to affluent persons so you can provide charity to the less fortunate neighbors is a clever and insidious manner of modifing the social economical balance. Businesses who provide these same services and products should be applauded for their tax money generation which should be the proper way to redistribute the wealth, and assist the needy.

In your deliberations, be mindful of the nature of free enterprise and fair competition. Let us strive to play on an even playing field.

Sincerely;

Charles J Novak

Charles J. Novak
BC-NBC HIS

CJN/ld

STATEMENT OF DANIEL OLIVER

CHAIRMAN OF THE FEDERAL TRADE COMMISSION

I would like to thank you for inviting me to testify on the important matters under consideration in these hearings. The testimony I will present is mine, not that of the Commission as a whole or any of my fellow Commissioners. My testimony will focus on the potential effects on competition and consumer welfare of the tax-exempt status of income-producing activities of nonprofit organizations under section 501 of the Internal Revenue Code.[1] My interest in the issues being addressed by this Subcommittee arises from the role of the Federal Trade Commission in evaluating competitive issues of the type raised by the unrelated business income tax rules,[2] and the FTC's experience in analyzing markets -- such as health care -- where tax-exempt nonprofit organizations compete with for-profit businesses.[3]

I would like to emphasize that my participation in these hearings is not motivated by a desire to increase tax revenues. Rather, I am concerned solely with the possible effects that section 501 has on competition between tax-exempt nonprofit organizations and taxable for-profit businesses, and on consumer welfare.

While I will confine my testimony to the federal income tax rules that are currently under consideration by the Subcommittee, I would like to preface my remarks with the observation that these rules are only one -- and probably not the most important -- of the numerous ways that federal, state, and local government policies favor nonprofit organizations.[4]

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[1] My comments address the following questions from the Committee's Press Release #25 (Sept. 12, 1986):

I.C.1. To what extent do tax-exempt organizations engage in income-producing activities that are being, or could be carried on, by taxable businesses?

II.C. What rationales underlie the various exceptions and modifications which permit tax-exempt organizations to engage in certain income-producing activities without taxation? For example, should endowment income be exempt from tax?

II.G. Do the present-law rules permit unfair competition by exempt organizations? If so, how should the rules be changed?

[2] In the Revenue Act of 1950, responding to concern over competition between tax-exempt and taxable businesses, Congress imposed a tax on the unrelated business income of organizations that were otherwise tax exempt under section 501. This tax was revised and expanded in the Tax Reform Act of 1969. The term "unrelated trade or business" means any trade or business that is regularly carried on and is not "substantially related," aside from the need of the organization for funds, to the performance of the purpose for which the organization was granted tax-exempt status. I.R.C. sections 511-514.

[3] Nonprofit corporations have a limited exemption from FTC jurisdiction. The proscriptions of the FTC Act apply to a corporation only if it is "organized to carry on business for its own profit or that of its members." 15 U.S.C. section 44. Under this provision, the FTC has jurisdiction over anticompetitive and deceptive activities of nonprofit associations and firms to the extent that they operate for the financial benefit of their members or constituents. See, e.g., American Medical Association v. FTC, 638 F. 2d 443 (1980), aff'd by equally divided court, 445 U.S. 676 (1982).

[4] At the federal level, in addition to the matters discussed in footnote 3, certain nonprofits also receive special treatment in connection with postal rates, Social Security, unemployment insurance, the minimum wage, securities regulations, copyright, and bankruptcy. U.S. Small Business Administration, Office of Advocacy, Unfair Competition by Nonprofit Organizations With Small Business: An Issue for the 1980s, June 1984, p. 26. At the state and (continued...)

Overview

When an activity is given an exemption from a general tax (such as the corporate income tax), the activity will be encouraged to expand, just as if the firm undertaking the activity received a government subsidy for it. Consequently, a tax exemption should be granted to an activity only when Congress has determined that the public interest would be served by encouraging expansion of that activity at the taxpayers' expense. Given the discussion in the media and the testimony that you have already received, there appears to be reason to believe that a significant amount of income-producing activity carried on by nonprofits now enjoys tax-exempt status that may not be in the public interest.

In determining whether a tax exemption is appropriate for income-producing activities of nonprofits, Congress should be mindful of two potentially harmful effects of such exemptions. First, exemptions for nonprofit organizations that compete with for-profit businesses put those for-profits -- especially small businesses -- at a competitive disadvantage. There have been many reports that nonprofits, such as colleges, universities, and hospitals, have used their tax-exempt status to engage in unfair competition with small businesses. In addition to their adverse effects on for-profits, exemptions for nonprofits competing with for-profits may make society as a whole significantly worse off. Society will be worse off if exemptions enable nonprofits to displace more efficient for-profits that would otherwise provide the goods and services in question at lower costs.

Second, subsidized activities are encouraged to expand. To the extent that tax-exempt activities yield income that is used for a nonprofit's core activities, those core activities will increase. But in addition, the tax-exempt income-producing activities are themselves subsidized and will expand. For example, although net income from a tax-exempt YMCA health club may be used to subsidize the YMCA's charitable activities, the tax exemption probably also subsidizes the health club. Thus, both the charitable activities and consumption of health club services will expand. One must question the merit of subsidizing income-producing activities that are at best remotely related to the principal purpose of the nonprofit entity.

Unfortunately, our understanding of the effects of tax exemptions and other policies favoring nonprofits, and of possible changes in these policies, is severely limited by scarcity of relevant data and of empirical studies of nonprofit organizations. Additional work would certainly be very useful as a basis for determining how to reform the federal tax treatment of the income-producing activities of nonprofit organizations. I therefore recommend that a thorough study of the tax treatment of nonprofits be commenced by an appropriate agency, perhaps the Department of the Treasury, and that the study make recommendations for any appropriate changes.

Which Core Nonprofit Activities Should be Subsidized?

Consideration of the desirability of giving nonprofits tax-exempt status for some activities should begin with an examination of the circumstances that can justify such exemptions. Government subsidies may serve the public interest when they remedy a failure of the private market to supply adequately particular goods and services that consumers want, or when they facilitate transfers between different groups in a manner desired by society. For example, without government subsidies, private firms might have insufficient incentives to undertake basic research because of their limited ability to prevent other firms from using the results of the research without paying for the right to do so. This may provide a justification for subsidies for some basic research carried on by universities and other nonprofit organizations. Other activities should be accepted for a list of core activities only if a similar

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[4](...continued)
local level, certain nonprofits also receive exemptions from income, property, and sales taxes.

rationale can be clearly articulated. As an example, suppose that Congress were asked to place proprietary applied research -- as opposed to basic research -- on the list of core activities that are desirable to subsidize. Because firms engaged in proprietary applied research would be able to charge users of their output for the benefits they receive, one would expect such research to be adequately supplied without subsidies, and hence a tax exemption would not normally be in the public interest.

Indeed, the tax laws have been interpreted and amended in a manner that has denied tax exemptions to nonprofits in a variety of circumstances. For example, in the Tax Reform Act of 1986 Congress eliminated the federal income tax exemption for nonprofit organizations, such as Blue Cross and Blue Shield plans, that provide commercial insurance in competition with for-profit insurers.[5]

Subsidies for Non-Core Activities

The next step in reviewing the tax treatment of income-producing activities should be to consider the justifications for tax exemptions for non-core activities. This step involves two questions. First, do all the non-core activities that have been given tax exemptions under the "substantially related" standard warrant subsidies? By way of illustration, one might raise doubts about the justification for subsidizing university stores selling clothing and records to students, university laboratories competing with private labs for testing contracts in areas such as soil analysis and environmental pollution, and hospital sales of drugs and lab analysis services for nonhospital patients. Second, are the existing exceptions to the "unrelated" business income tax -- including exceptions relating to convenience, research, and royalties[6] -- warranted, and do all the non-core activities that have avoided taxation under these exceptions merit subsidies? A few examples may be useful. The convenience exception, like the substantially related standard, may be used to extend tax exemptions to activities such as university travel services. The research exception can be used to exempt proprietary applied research for commercial customers. The royalty exclusion may exempt royalties earned by a nonprofit that licenses its name or logo for use in marketing consumer goods.

When nonprofits receive a tax exemption for activities outside their core areas, they may be able to earn profits that they can use to provide additional subsidies to their core activities. At first glance, this may seem like a good thing as long as a tax exemption is justified for the core activity. But two problems may make exemptions for non-core activities a wasteful method of promoting core activities.

The first problem with providing tax exemptions for non-core activities is that the exemptions enable nonprofit firms to sell goods and services at subsidized prices and gain market shares at the expense of nonsubsidized for-profit firms -- even though the tax-exempt firms may be less efficient. Where the nonprofit firms are less efficient, there will be a waste of society's resources because higher cost firms will displace lower cost ones.

Why do I expect that some subsidized nonprofit firms will be less efficient than their nonsubsidized for-profit counterparts? I would not be the first to observe that nonprofits may have higher costs than for-profits because their profit motive is attenuated. However, there is a much more important explanation. Whenever some firms are subsidized and others are not -- regardless of whether they are nonprofit or for-profit -- the subsidized firms may be able to survive even if they are less efficient.

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[5] In addition, nonprofit automobile service clubs are not tax exempt. See Chattanooga Auto. Club v. Commissioner, 182 F.2d 551 (6th Cir. 1950); G.C.M. 23688, 1943 C.B. 283, as modified by Rev. Rul. 69-635, 1969-2 C.B. 126.

[6] The convenience exception excludes from the term "unrelated trade or business" any trade or business carried on by a relevant organization for the convenience of its members, students, patients, officers, or employees.

Let me give a hypothetical example to show how society's resources can be wasted by subsidization of inefficient producers. Assume that a nonprofit organization has decided to set up a health club for the convenience of its members. Assume further that there are no taxes on the incomes of either the nonprofit or the for-profit health clubs, and that it would cost the nonprofit health club $500 to produce annual services for a member while it would cost the for-profit club $450 to produce the same services. In this hypothetical, the nonprofit would not be able to compete. Now assume that the for-profit is subject to taxes that amount to $100 per member, while the nonprofit health club is left tax exempt. The for-profit would have to charge $550 for a membership. The nonprofit club could now offer memberships at a subsidized price of $525, and gain sales at the expense of the for-profit club. Society would be worse off, because the membership services that would have entailed only $450 in real costs (excluding taxes) to society if produced by the for-profit firm will now be produced by the nonprofit club at a real cost to society of $500. The exemption is responsible for a waste of $50 per member. Suppose, for example, that the source of the relative efficiency of the for-profit is that it is able to supply the same services as the nonprofit but with 5 hours less labor per member. The extra 5 hours of labor used by the nonprofit are wasteful, since those 5 hours could be used in some other productive activity.

To sum up, the first problem with conferring tax-exempt status on income-producing activities of nonprofits is that it may cause an inefficient producer to displace an efficient one. There is also a second problem. Even if nonprofits are no less efficient than for-profits, conferring tax-exempt status on nonprofits engaged in non-core income-producing activities will increase the total volume of such non-core activity in the economy. Unless the non-core goods and services in question would have been undersupplied by nonsubsidized for-profit firms, this expansion of the non-core activity would be wasteful. We would end up with the non-core goods and services offered to some consumers at a subsidized price, which would encourage consumption even when the goods and services were valued at less than their true social cost. In a nutshell, conferring tax-exempt status on the non-core activities of nonprofits can be a wasteful way for society to increase the amount of funds available for core nonprofit activities.

Besides the loss in efficiency that can arise from tax exemptions for nonprofits operating in non-core activities, this subsidization of nonprofits is likely to have an adverse effect on for-profit businesses with whom they compete. In view of the type of income-producing activities typically undertaken by nonprofits, the adverse competitive effects may fall disproportionately on small businesses. The press and the Small Business Administration have reported many complaints that nonprofit organizations --such as colleges, universities, hospitals, and YMCA's -- have used their tax status to engage in "unfair competition" with small businesses.

These problems of inefficiency and competition with for-profits warrant the exercise of considerable care in conferring tax-exempt status for income-producing activities of nonprofits.

Another Problem with Nonprofit Subsidies

I have suggested that nonprofits may not have the same incentives as for-profits to keep costs to a minimum and to provide consumers with the best types of goods and services, because of the attenuation of the profit motive for nonprofits. In addition, it cannot be taken for granted that laws prohibiting the distribution of net earnings to the operators of nonprofits will necessarily prevent operators from using subsidies for personal gain, such as in the form of inflated salaries or perquisites. Therefore, even if subsidization of particular activities is determined to be worthwhile, there may be cases where a tax exemption should not be provided to nonprofits.

Benefits of Unsubsidized Competition

I want to make clear that my main concerns with the income-producing activities of nonprofits arise when they are subsidized, whether by tax exemptions or by other policies. For-profit businesses have in some instances complained about competition from income-producing activities of nonprofits that are not given tax-exempt treatment. I would not have the same concern about nonprofits undertaking activities that are not subsidized (although in some circumstances there may be legitimate concern about the possibility of cross-subsidization).

Passive Investment Income

I would like to make one point concerning the competitive effects of tax exemptions for nonprofits in response to the Subcommittee's question concerning the tax exemption for "passive" investment income from endowments. If taxes were imposed on passive investment income, tax-exempt nonprofits would be encouraged to shift their capital from passive investments into enterprises in which they would compete on a subsidized basis with for-profit businesses. For the reasons discussed above, such a development would be undesirable.

Tax-Exempt Public Sector Firms

As this Subcommittee addresses the tax-exemption issue, I believe it is useful to keep in mind that private nonprofits are not the only tax-exempt organizations competing with private for-profit firms. Governments themselves -- federal, state, and local -- constitute the largest tax-exempt sector of our economy. Governments compete with private for-profit firms in activities such as mail delivery, waste disposal, and urban transportation, and in some cases governments go so far as to prohibit any competition from private for-profit firms. As with nonprofits, there is reason for concern about the effect of these governmental activities on competition and on the allocation of society's resources.

Recommendation

I believe that the tax treatment of income-producing nonprofits raises sufficient concerns to warrant a thorough review of this policy. It is possible that the current tax treatment of nonprofits results in a significant loss of efficiency and competitiveness in our economy. Therefore, I recommend that a study be commenced by the appropriate agency, perhaps the Department of the Treasury, for the purpose of developing recommendations on the appropriate tax treatment of nonprofit organizations.

Thank you for the opportunity to present my views on these important issues.

ORANGE
HEARING
AIDS
C.L. 'Kip' Miller
Betty Miller
Owners
Board Certified
by
National Board for Certification
in Hearing Instrument Sciences

June 19, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways & Means, U. S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D. C. 20515

Dear Sir:

During the last year, Providence Speech and Hearing - a non-profit organization in Orange, California - has expanded its operations from Speech Rehab and Testing of Children for Hearing Loss to the Selling and Fitting of Hearing Aids.

My objection to this approach is: Providence Speech and Hearing pays little or no taxes as a non-profit organization, it has many free radio and T.V. spots, mails the same type of direct mail newsletter as I to attract clients - yet their cost for postage is half of what I must pay, city and county license cost are greatly reduced. In addition, the "halo" effect of this non-profit is a non-measurable advantage. This organization receives donations from industry and individuals because they are, under the IRS regulations, a non-profit and these donations can be written off.

I must pay the full price to compete in the free market - they should loose their non-profit status if they continue to compete with private enterprise.

Sincerely,

Kip Miller

Elizabeth "Betty" Miller
C. L. "Kip" Miller
Licensed Dispensers

/b

CHAPMAN PROFESSIONAL PLAZA
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COMMITTEE ON
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WAYS AND MEANS

Robert J. Leonard, Chief Cousel
Committee on Ways & Means
U. S. House of Representatives
Room 1102, Longworth House Office Building
Washington, D.C. 20515

Reference: Written statement in lieu of a personal appearance regarding hearings and reviews of unrelated business income tax for tax exempted organizations; press release #10 060387

Mr. Leonard:

Since 1985, this writer has been conducting a research project related to tax exempted section 3-501 (c) 3 organizations. The research focuses on the tax exempted organization's structure, management, purposes, financial management and compliance with all state and federal statutes, plus sources of income from contributions and unrelated taxable income.

The research todate appears like being in some South American jungle.

c/P.2

P.2 of 6.

Perhaps some improvement in access to I.R.S. files on these tax exempted organizations would improve the understanding of some of the discovered abuses of state and federal laws would inform the public better.

How can one believe the financial statements given out by these organizations, when the reports have not met GAAP (generally accepted accounting principles) requirements?

Most states have laws, that many of these organizations feel that they "are above the laws", because they are tax exempted. And who in the state and federal government and its agencies are enforcing the laws to the spirit and letter of the various laws? Not the I.R.S.

Examing these organizations bylaws and their charters is another trip to the "funny farm", very little agreement of either document. And then you examine their fin-

c/P.3

P.3 of 6

ancial statements and its a reminder of one's first ride on a Ferris wheel or merry go round. As their does not exist any standard method or form how any transaction or source of income is to be treated...... each little organization is "allowed" to make it's own little ways of how it will treat, record or account its source of income and expenses. Forget a balance sheet, as those usually are available only at times of financing a mortgage or floating a bond issue to whoever.

Unrelated business income? Most of the organizations examined or officers queried, treat this the same as a tax exempted contribution.

And who operates and manages most of these organizations? Volunteers, that usually have very little knowledge of the correct business manner of how the organization is organized, functions, managed or what their responsibilities are to the public or state or federal agencies.

c/P.4

They (volunteers) could care less whether the current methods are wrong.... their is no motivation or purpose to change ...... the I.R.S. does not examine their tax files (if they're filed at all) as is a requirement of any small business or corporation-for-profit.

So, the question is, why is these sloppy managed, non Complying organizations allowed to compete against profit making—tax paying small and large for-profit enterprises? There is no Comparison.

Small tax exempted organizations who operate their finances out of a shoe box, make a substantial unreported taxable income and don't file a tax report, yet they can pay good salaries, that often may be tax exempted (as in pastor's housing allowances in the churches) and have no fear that the I.R.S. will come and close them tomorrow. Is this equal but fair? Unconstitutional.

Then some organizations offer a prod-

c/P.5

P. ~~#~~ 5 of 6

uct or service to non members with selling prices that may be greater than the for profit merchant. But, why are these non profits able to reap substantial profits without a tax liability (income taxes and property taxes)?

If this unrelated business income is allowed to continue to be a parasite on behalf of the expense of the for profit-tax paying-ventures, eventually, the for profits may learn (what already has not been learned) all the tax advantages that the tax exempts enjoy. Then where will the tax dollars to support the armies, social security, welfare and schools come from?

My position is: this (unrelated business income for tax exempts) is another massive abuse that is being exploited against the American taxpayer. Let's cut out this massive abuse; pass or amend laws that will encourage and spawn more for profit organizations that pay taxes;

c/P.7

P.#6 of 6

And pass new laws or amend existing laws that will *restrict* the non profits to their charters purposes and if they are to compete against the for profit organizations, make *and enforce* the laws, legal requirements so that the not-for-profits do not have a substantial advantage on how the organization is managed, paying state, federal unemployment, property taxes, social security, housing allowances, sales taxes, etc. And mostly, any non profit *must* file a income tax file that will be examined, audited on a equal basis as a for profit organization does/is.

Right is right, and wrong is when a not for profit has a advantage over any for profit organization.

Thanks for allowing this opportunity to express some findings my research has discovered.

Sincerely,

RK Powell

R. K. POWELL
1925 FAIRLAND Rd.
Silver Spring, Md. 20904

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Russel Building
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Bismarck, North Dakota 58502 (P.O.)
223-5807

6-11-87

To: Robert J Leonard
Committee on the Ways and Means

Subject: Unfair Competition from Non-Profits Organizations.

Gentlemen,

Attached is just some brief information regarding non-profit's which compete against private practice. Action has been tried thru the North Dakota Secretary State, the North Dakota Attorney Generals office and the North Dakota Representative Byron Dorgan, all with no results.

As you will note a local non-profit receives States Funds as well as Gaming Funds and Donations and then retails Hearing Aids to the general public. This non-taxable system is impossible to compete against and survive with. It is very simply a large Loophole that many organizations use to retail and avoid the struggle of normal business overhead.

It would seem very simple to say that if All Non-profits could not retail then the Consumer, Private Business and The Government in need of revenue from the Non-profits going into private business and then paying their share of taxes would all benefit.

We hope this information is of benefit to your committee meeting.

REGARDS

SCHAUER HEARING AID CENTER'S OF NORTH DAKOTA

Floyd Schauer, Ron Schauer, Doug Schauer, Ned Schauer and Fred Schauer

FLOYD F. SCHAUER
Certified Hearing Aid Specialist

RON R. SCHAUER
Certified Hearing Aid Specialist

DOUG D. SCHAUER
Hearing Aid Consultant

NED N. SCHAUER
Hearing Aid Specialist

Coming to Grips With Nonprofit Competition

by William J. Mahon

Ever wonder what nurserymen and tour-bus operators have in common? Or billboard companies and veterinarians? Travel agents and testing laboratories? How about commercial laundries and hearing aid dispensers?

Understandably, unless you've had an exceptional amount of time on your hands lately, your mind probably hasn't wandered quite that far. Despite their obvious dissimilarities, however, all of those odd couples share at least one trait (or fate, some would say): All are among the wide range of businesses that increasingly find themselves facing direct competition in their respective fields from tax-exempt, or even tax-supported, nonprofit entities that have "gone commercial" — selling on the open market goods or services identical to their own, often at a significantly lower price, as a means of generating revenue. So widespread has that commercialization among nonprofits become, says the U.S. Small Business Administration (SBA), that the nonprofit segment of the U.S. economy now accounts for 10.5% to 11% of the nation's $3.5-trillion gross national product (GNP).

Who are these nonprofits that are giving for-profit businesses a run for their money? The field is virtually limitless, including, for example: (1) zoos and museums that sell all manner of retail items in their gift shops, (2) hospitals that literally "take in laundry" for other institutions at better rates than commercial launderers', (3) universities that sell time on their computers and offer testing-lab services, (4) a state forestry agency that bid for seedling contracts against commercial nurseries in its own state, (5) Planned Parenthood of America, Inc. marketing its own line of contraceptives, (6) state or federal agencies that are replacing billboards near highways with uniform roadside signs alerting motorists to the Burger King or Exxon station off the next exit, (7) university travel centers that compete with commercial travel agents in the group-travel business, and, among many others, (8) nonprofit hospitals and speech-and-hearing clinics that dispense hearing aids in competition with retail hearing aid centers or private-practice dispensing audiologists.

To the nonprofits, such commercial activity represents a reliable new source of revenue — something that many nonprofits say they need in order to stay afloat and fulfill their primary missions in an era of cuts in government funding and declines in charitable gifts and private grants. Furthermore, many argue, not only is there nothing wrong with a nonprofit entity paying its own way through entrepreneurial skill — the idea is downright commendable.

To their for-profit competitors — and to the SBA's Office of Advocacy — however, much of the nonprofits' commercialism amounts to patently unfair competition with the business community, given the nonprofits' exemption from federal, state, and local taxes, their subsidized postage rate, and other privileges not available to business. Armed with those financial advantages, business argues, it is no wonder that many nonprofits can easily undersell their profit-based competitors; the nonprofits' prices need not reflect the real costs of doing business. And in what to them represents the system's most serious philosophic affront — competition from government agencies or other tax-supported nonprofits — businesspersons complain that part of their own tax dollars are being used to subsidize their competition.

The question of what, if anything, should be done to curb the nonprofits' perceived competitive advantages is receiving increased attention both from business and within the federal government, and as is evident in the nonprofits' financial profile, it amounts to a major philosophic and practical issue for the American economy. As we will see, the types of solutions proposed to date (all of which are still in the discussion stage) do not focus on prohibiting nonprofits from engaging in commercial activity. Instead, they are aimed at evening the competitive odds by increasing the nonprofits' potential tax liability on commercial income.

THE NONPROFIT BOOM

Estimates of the number of nonprofit entities currently active in the United States vary. The U.S. Treasury, for ex-

United Way outlines way it spends your money

By DORIS HAUGEN
Sun Family Editor

The money raised in this year's United Way campaign will be allocated to 16 agencies, all of them serving people from the Jamestown area.

"The money raised by the people of Jamestown through United Way stays here to help neighbors," said Jake Wolf, president of the local organization.

The money raised is used to provide a variety of services ranging from programs for youth to transportation for senior citizens to services for the victims of domestic violence.

This year United Way's Board of Directors has set a goal of $110,000 for its 1986 campaign, about a five percent increase over last year's campaign goal.

Of that goal, the United Way board expects over 50 percent to be donated by individuals while the balance will be made up through contributions by businesses.

The $110,000 goal was set in July after a formal hearing process in May and review by the United Way's finance committee. Formal requests came from 19 agencies this year, 16 have been allocated funding for 1987.

The three agencies asking for funds were denied an allocation because they did not meet United Way stipulations. To qualify for funding organizations must be non-profit and show an operational track record of at least one year, Wolf explained.

Criteria used by the United Way to determine how much an agency's allocation will be is based on three areas: who will benefit, what the funds will be used for, and how many area people the agency serves.

Once the United Way meets its goal, money raised in the campaign will be distributed to agencies beginning in January of 1987.

The largest portion of United Way money will be spent on community service programs. The programs and their allocations are the Senior Citizens Center, $12,000; Speech and Hearing Services, $9,000; the Salvation Army Harbor House, $20,000; and Camp Rokiwan, $2,000.

The second largest portion of the funds raised in the campaign will go to programs for local youth, Wolf said. Youth programs funded with United Way money are the Boy Scouts, $5,000; Girl Scouts, $6,000; Youth Baseball, $4,500; and the YMCA's Youth Program, $10,000.

The balance of funds raised will be allocated to the following agencies providing health and safety programs, emergency and crisis intervention, and counseling.

They are the American Red

See UNITED WAY on page 2

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State of North Dakota

Ben Meier
SECRETARY OF STATE
701-224-2900

Robert R. Schaible
DEPUTY

DEPARTMENT OF STATE
Bismarck, North Dakota 58505

February 27, 1986

Mr. Ronald R. Schauer
1209 5th Ave. S.E.
Jamestown, ND 58401

Dear Mr. Schauer:

Our office is in receipt of your recent letter concerning Speech and Hearing Services, Inc.

Your letter made reference to N.D.C.C. section 10-24-02, s 3. That section talks about "Bylaws" of non-profit corporations and the description of bylaws.

Our office is here to see they organize their business according to law. If you feel it is an unfair advantage to your business perhaps you should write to the Director of Human Services or the Governor and express your concerns.

If our office may be of further assistance, please write.

Sincerely,

Robert R. Schaible

ROBERT R. SCHAIBLE
DEPUTY SECRETARY OF STATE

RRS:emb

Ben Meier
SECRETARY OF STATE
701-224-2900

State of North Dakota

Robert R. Schaible
DEPUTY

DEPARTMENT OF STATE
Bismarck, North Dakota 58505

December 11, 1985

Schauer Hearing and Sales & Service
1209 5th Ave. S.E.
Jamestown, ND., 58401

Attn: Ronald R. Schauer

Dear Mr. Schauer:

Thank you for your letter of December 9, 1985, concerning Speech and Hearing Services, Inc. in Jamestown, North Dakota.

Enclosed is a copy of the North Dakota Nonprofit Corporation Act. Pursuant to this provision of law, the Secretary of State has no regulatory authority to investigate the business activities of a non-profit corporation.

Perhaps you may wish to bring this matter to the attention of both the North Dakota Tax Commissioner and the Internal Revenue Service.

Sincerely yours,

Ben Meier

BEN MEIER
Secretary of State

BM/cj

Enc.

SCHAUER
HEARING AID
CENTER

1209 5th Ave. S.E. Jamestown, N.D.
252-8446, The certified and Licensed Hearing Aid Professionals

2-24-1986

TO: Secretary of State
Dept. of State
State Capitol Bldg.
Bismarck, N.D. 58505

ATTN: Robert R. Schaible

Gentlemen,

Follow up to our last letter requesting clarification of N.D. CC# 10-24-02 #3. See attached public notice in Feb. 21st Jamestown Sun. Speech & Hearing gets payed by the state for Services which are offered "FREE" by most hearing Aid dispensers, and offered free by Schauer Hearing Aid Center. After that they "request" donations and SELL Hearing Aids, which by now should be 100% profit. It is difficult, if not impossible for the private sector to compete against these odds and still make enough money to pay our TAXES to the state of North Dakota.
Your continued clairifcation is expeected.

Regards,

RONALD R. SCHAUER

STATE OF NORTH DAKOTA
Robert O. Wefald
Attorney General
State Capitol
Bismarck, North Dakota 58505

701-224-3404
800-472-2600
TOLL FREE IN ND

CONSUMER FRAUD AND
ANTITRUST DIVISION

IN CORRESPONDENCE REFER TO

November 26, 1982

Floyd F. Schauer
Schauer Hearing Aid Service
301 15th Avenue N.E.
Jamestown, North Dakota 58401

Dear Mr. Schauer:

Thank you for your letter of November 8, 1982, concerning Speech and Hearing Services, Inc., in Jamestown, North Dakota.

The Attorney General and members of his staff are not authorized to give legal advice or assistance to private businesses or members of the general public. We may only serve as legal advisors to state officials, state's attorneys, and certain city officials. We therefore urge you to seek the services of an attorney engaged in the private practice of law and rely upon his or her best judgment and advice as to how to proceed on this matter. However, we do offer the following general discussion for your assistance which should not be considered as a formal legal position of this office.

As you may know, Chapter 43-33 of the North Dakota Century Code regulates hearing aid dealers and fitters. There are no provisions under Chapter 43-33, N.D.C.C., which prohibit a nonprofit organization from the selling or fitting of a hearing aid so long as that entity is properly licensed with the State.

I trust that this information will be of some assistance to you.

Sincerely,

Daniel Hovland

Daniel Hovland
Assistant Attorney General

ja

Schauer Hearing Aid Service
Floyd Schauer
301 15th Ave. N.E.
Jamestown, No. Dak. 58401
November 8, 1982

Robert Wefald
Attorney General
Bismarck, No. Dak.

Dear Sir:

I am an independent Hearing Aid Dealer with a North Dakota State Hearing Aid Dealer and Fitters License. I dispense hearing aids in the Jamestown area.

I would like to know if the Jamestown based Speech & Hearing Service, Inc. is a state tax supported organization and thus would be in conflict of interest by being a non-profit organization using state tax funds, to compete against private hearing aid dealers (Private enterprise).

If not state tax supported, would they be in conflict of interest by being a non-profit organization using charitable fund donations to compete against private enterprise.

The Speech & Hearing Service Inc. is listed as receiving funds from the United Fund and from local service clubs. It also advertises the sales of Hearing aids. Attached is a list of articles as they appeared in the local newspaper.

I would appreciate a ruling on this issue because my continuing in the hearing aid sales business depends on whether I must compete against this type of competition. Thank You.

Yours Truly,
Floyd F. Schauer
Schauer Hearing Aid Service

State of North Dakota

Ben Meier
SECRETARY OF STATE
701-224-2900

Robert R. Schaible
DEPUTY

DEPARTMENT OF STATE
Bismarck, North Dakota 58505

January 21, 1985

Mr. Floyd Schauer
Schauer Hearing Aid
Sales and Service
1209 - 5th Avenue S.E.
Jamestown, ND 58401

Dear Mr. Schauer:

Thank you for your recent letter regarding nonprofit corporations competing with businesses.

The information that you supplied and the issues that you raised are interesting. However, state law does not appear to be black and white on nonprofit corporations copeting with businesses. As you suggest in your letter, you may wish to contact your legislator about sponsoring a resolution calling for an interim study of the issue.

Enclosed I am returing your information in case you wish to share it with others.

Sincerely,

Ben Meier
BEN MEIER
Secretary of State

BM:gjk

Encls.

SCHAUER
HEARING AID CENTER

1209 5th Avenue S.E. ● Jamestown, ND 58401
252-8446

Russel Building
(Highway 83 North 1 mile north of K Mart)
Bismarck North Dakota 58502 [illegible]
223-5807
(Formerly Acousticon of Bismarck)

3-6-1987

TO: Representative
Byron L. Dorgan

Dear Representative Dorgan,

Regarding your letter of Feb. 20, 87 and it's request to work with businesses of North Dakota. In that letter you ask to let you know of ideas to improve the economy of North Dakota. Since taxes seem to be of everyones concern attached is one of our main conerns and also the third main conern of small business in general in the United States. We feel it will help the tax probelm considerably.

If nonprofits were dealt with properly and prohibited in general then the tax revenue that would be brought about by those firms then having to pay their fair share would all but eliminate our tax revenue problem. We have been in contact with the North Dakota Attorney General's office as well as the Secretary of State and our files have letters of feeble excuses and "I'm sorry" with no one with the fortitude to address the issue, correct the problem and bring about some results.

Feel free to stop in one of our offices at anytime and discuss this and other matters.

Regards,

THE SCHAUER'S

cc; "Grips with Nonprofit", "SBA Report"

FLOYD F. SCHAUER
Certified Hearing Aid Specialist

RON R. SCHAUER
Certified Hearing Aid Specialist

DOUG D. SCHAUER
Hearing Aid Specialist

NED N. SCHAUER
Hearing Aid Specialist

Hearing Aids

We offer quality, local service. Try before you buy. Check out our reasonable prices and service policy. Guaranteed satisfaction. Complete hearing testing and hearing aid evaluations.

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SPEECH & HEARING SERVICES, INC.

Non-Profit Agency
Box 336
Jamestown, ND
Phone 252-4100

Michelle Kleingartner, M.A. CCC-A
Audiologist

Tickets

	Advance	Door
Child's (K-12)	$2.50	$3.00
Adults	$3.50	$4.00

(Advance tickets can be purchased from skaters, 2 Plus 2, and The Total Look)

Show Times

Friday, March 20, 7:30 p.m.
Saturday, March 21, 2 P.M. — Benefit Show and 7:30 P.M.
Sunday, March 22, 2:00 P.M. and 7:30 P.M.

"Most Val
scholarships aw
by B.P.O. Elks we
town High School g
seniors, Tim Rodgers and
ra Edin.

George L. Barron, scien
teacher in Jamestown Hi
School, has been selected Nort
Dakota's Outstanding Physica
Science Teacher for 1976-77.

Speech, hearing clinic planned

A speech and hearing clinic for senior citizens will be held Tuesday, March 31, from 9:20 a.m. to 3:20 p.m. at the Senior Citizens Center No. 1 in Jamestown.

The clinic will offer diagnostic hearing testing, counseling, and referral services and minor hearing aid repairs by Michelle Kleingartner, clinical audiologist.

Donations will be accepted in support of the services but services will be offered regardless of ability to pay. The program is funded by Aging Services, North Dakota Department of Human Services, through a Title III Service Grant.

UNRELATED BUSINESS INCOME TAXATION
COMMENTS BY THE SOCIETY OF NATIONAL ASSOCIATION PUBLICATIONS

1010 Wisconsin Avenue, N.W.
Washington, D.C. 20007

These comments are submitted by the Society of National Association Publications (SNAP). SNAP was formed in May of 1963 to provide a means for several hundred publications published by professional societies and trade associations to improve their service to their readers and contribute more effectively to the development of the professional, business and technical press.

In announcing the formation of the organization, it was stated that "trade associations and professional societies play an extremely important role in the operation and perfection of the free enterprise system in America, providing as they do the means of sharing technical and commercial knowledge." Members of SNAP include such publications as The New England Journal of Medicine, published by the Massachusetts Medical Society; IEEE Spectrum, published by the Institute of Electrical and Electronic Engineers; The American School Board Journal, published by the National School Boards Association; and Electrical Contractor, published by the National Electrical Contractors Association.

Just as associations and societies nationwide represent a diversity of interests and constituencies, SNAP membership is drawn from associations and societies whose members may be quite different. The SNAP membership has a common interest in: (1) promoting and advancing the interest of all periodicals which serve their organization members; (2) developing and maintaining high standards of editorial content and of publishing practices for such journals and publications; and (3) providing an exchange of information and views on matters of importance to society and association publications.

SNAP's membership represents more than 190 periodicals employing a range of publications' professionals including publishers, editors, advertising managers, and others. Disseminating specialized information fulfills a major purpose of most associations and societies. One of the most effective methods of disseminating such information is through the periodicals which SNAP members publish. For many associations, the primary link between the society and its membership is its magazine or journal. For members this periodical may be the best and, in some cases, the only source of current and factual information about their industry, trade and/or profession. These periodicals are often the major form for assisting their associations in fulfilling their tax-exempt purposes.

Official association publications provide, in most instances, the primary communication link with members and are a source of information for the public as well. As such, specialized publications demonstrate a deep understanding of the problems of the industry and professions that they serve and the needs of individual association members. The publications provide a direct and efficient means of communicating with manufacturers, wholesalers, professional people, and others who comprise virtually all that sector of the economy.

It is common for associations and professional society publications to include advertising. Under the present tax laws, there are specific regulations with regard to advertising income of nonprofit organizations. In essence, these regulations provide that net advertising income, when defined by certain formulas, constitutes unrelated business income and is therefore subject to tax.

The present regulations have attempted to balance the need for associations and professional societies to publish magazines and journals and obtain revenue therefrom to support tax-exempt purposes with the requirements of fairness in taxing unrelated business income. Essentially the current regulations recognize that an association or professional society publication is entitled to include advertising and that such advertising provides educational information to the readers as well as providing benefits to the advertiser.

There have been some proposals to change the law and regulations as they now apply to advertising income of nonprofit organizations. One proposal that has been discussed recommends that all advertising income rather than net advertising income be subject to the unrelated business income tax. We strongly oppose any such change in the law or regulations. It must be clearly understood that the most significant portion of an association or professional society publication is devoted to materials such as articles, studies, learned presentations, and technical papers, directly related to the tax-exempt purpose of the organization. As such, an equally significant portion of the expenses going into the publication is directly related to the exempt purpose of the organization. Advertising income plays an important part in getting this information to the public and thus supports the exempt purpose of the organization. It would be unfair and against public policy to tax all gross advertising income.

One could also argue that net advertising income should not be taxed as advertisements placed in trade magazines are generally aimed at providing specific technical information to a limited group of readers and thus supports the purpose of the organization.

We would, however, recommend the following:

1. IRS should strictly enforce the UBIT rules so that any organization abusing its tax-exempt status be appropriately dealt with under the law.

2. IRS should review the language in the regulations governing advertising income for tax-exempt organizations. Some of the language in these regulations is confusing and we think that the regulations should be clarified.

3. IRS Form 990-T for reporting unrelated business income, including advertising income, should be reviewed to determine if a more comprehensive and simpler to understand form can be developed.

4. Leaders of the nonprofit community and representatives of small business should meet and communicate regarding their mutual concerns in this area. We think that there is a community of interest between nonprofit publications and for-profit publications and a forum should be established so that this community of interest could be developed for the betterment of the people of our nation.

5. No additional laws or regulations should be issued which would increase the tax on advertising income of nonprofit organizations.

The Society of National Association Publications thanks you for the opportunity to present these comments and we would be glad to submit any additional information or answer any questions that you may have.

STATEMENT OF
THE SOCIETY OF THE NEW YORK HOSPITAL
CONCERNING THE UNRELATED BUSINESS INCOME TAX
BEFORE THE OVERSIGHT SUBCOMITTEE OF THE
HOUSE WAYS AND MEANS COMMITTEE

July 17, 1987

The Society of the New York Hospital ("New York Hospital" or "Hospital") is pleased to present this statement concerning the unrelated business income tax on activities of nonprofit institutions to the Oversight Subcommittee ("Subcommittee") of the House Ways and Means Committee. Few issues are more important to nonprofit organizations than assuring adequate resources for the growing demands society places upon them.

Founded in 1771, New York Hospital is one of the nation's leading medical care, teaching and research hospitals. Since 1927, the Hospital has been formally affiliated with Cornell University Medical College. The facilities of the two institutions are jointly used for the advancement of patient care, medical education and research. The Hospital operates a 1,096-bed acute care general hospital in New York City and maintains close affiliations with, among others, several neighboring institutions, including the Hospital for Special Surgery, a tertiary orthopedic and rheumatic disease hospital; the Rockefeller University, a scientific, biomedical and clinical research institution with inpatient care facilities; and the Memorial Hospital and Sloan-Kettering Institute for Cancer Research. The Hospital also operates a 322-bed acute care psychiatric hospital in White Plains, N.Y. These activities permit New York Hospital to serve the health care needs of the New York area, the nation and the world. To meet these needs, however, adequate financial resources are essential.

The Subcommittee's recently concluded hearings provided an important forum to discuss these financial needs and the operations of the unrelated business income tax ("UBIT"). In shaping any legislative proposals, the Subcommittee should consider the following points:

(i) The tax-exempt status of nonprofit hospitals is essential to the continued level of health care services they provide. See pp. 2-3, infra. The federal government should not undercut nonprofit hospitals' ability to provide such services. Proposals to limit or eliminate the tax-exempt status of such hospitals therefore should not be considered.

(ii) The current "substantially related" standard provides a reliable, well-developed test to determine which income-producing activities of nonprofit organizations should be subject to the unrelated business income tax ("UBIT"). See pp. 3-5, infra. Testimony at the hearings demonstrates that many of the activities about which small business complains are already subject to the UBIT. Suggestions made to the Subcommittee for improved enforcement and more guidance from the Internal Revenue Service ("IRS") would provide an improved mechanism for carrying out the current relatedness test and are preferable to changing the relatedness test or flatly banning certain income-producing activities.

(iii) The suggestions for further study that were advanced by the Treasury Department should be very carefully examined. See pp. 5-10, infra. Although proposals to improve reporting and enforcement have merit, other suggestions that might lead to limits on nonprofit organizations' research activities and their use of subsidiaries and joint ventures could be harmful to nonprofit institutions' ability to carry out their services to the public.

(iv) Any proposal for change in the UBIT is premature in the absence of reliable data on nonprofit institutions' finances and their income producing activities. *See* p. 10, *infra.* Congress should take no action until the IRS completes its taxpayer compliance measurement program of UBIT returns.

The following comments set forth the reasons for these recommendations.

I. THE CASE FOR NONPROFIT HEALTH CARE.

In light of the important services provided by nonprofit hospitals, the Subcommittee should not consider proposals to limit or eliminate the tax-exempt status of such institutions. From the earliest times of the nation, its citizens have depended upon nonprofit institutions to provide health care, as New York Hospital's pre-Revolutionary War origins demonstrate. The tax-exempt status of nonprofit hospitals is crucial to their continued service.

Two principal grounds have been advanced in support of the tax-exempt status of such nonprofit institutions. First, tax exemption supports the freedom of citizens to organize associations for public purposes, which is a vital part of the pluralism at the heart of American society. As one commentator explains, "[t]o tax these entities would be to flatly repudiate and contravene this doctrine [of pluralism] which is so much a part of the nation's heritage." Hopkins, *The Law of Tax Exempt Organizations* (5th ed. 1987) at 10 ("Hopkins at __.").

The tax-exempt status of hospitals and other nonprofit institutions is also explained on a second, more practical ground. Nonprofit hospitals perform functions which, in their absence, would otherwise become the responsibility of the government, as the House Ways and Means Committee recognized in 1939:

> The exemption from taxation of money or property devoted to charitable and other purposes is based on the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from promotion of the general welfare.

H. Rep. No. 1860, 75th Cong., 3d Sess. (1939) at 19, *quoted in* Hopkins at 6. Today, in light of continuing reductions in federal support for health care, it is more critical than ever that nonprofit hospitals retain the tax exemptions that make their activities possible.

Testimony presented to the Subcommittee demonstrates the continuing need for health care institutions' tax exempt status. Bradford H. Gray, Ph.D., of the Institute of Medicine of the National Academy of Science, reported that 65 percent of all hospital beds in the nation are operated by nonprofit hospitals. Such nonprofit hospitals also provide 75 percent of uncompensated care. Testimony of Bradford H. Gray, Ph.D., at 2, 4.*

As Gray explained, the lower incentive for profit maximization among nonprofit hospitals permits them to put resources in areas that may not return a profit, including areas such as teaching and research. Nonprofit hospitals are "the locus of most of the nation's clinical research and educational activities," according to Gray. Gray Test. at 5. In its testimony, the Catholic Health Association ("CHA") reported that in 1980, of the 329 major teaching hospitals in the nation, 248 were nonprofit and the rest were public. CHA Test. at 4.

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* Subsequent references to written testimony presented at the hearing will indicate the abbreviated name of the witness after the page, *e.g.*, [Name] Test. at ___.

Any change in this tax-exempt status could be seriously harmful to nonprofit hospitals and the communities they serve. Taxing nonprofit hospitals would force them to close or eliminate unprofitable services and charge more for their remaining services. The burden of these reductions would fall largely on those least able to pay. Vital teaching and research functions also would be curtailed. Pressures to enter new profitable businesses would only increase -- an ironic result, in light of the concerns of small businesses about competition from nonprofit organizations. In the absence of tax exemption, financing for new hospital construction and equipment could become prohibitively expensive. Government would be called upon to assume the cost of these services. Avoiding such costs is, of course, precisely one of the reasons why tax exemption was granted to nonprofit hospitals initially.

Nonprofit hospitals continue to play a vital role in the nation's health care system. As Gray urges, public policy should "encourage such behavior [to promote health care] on the part of hospitals," but this "cannot be done by undercutting their ability to finance important services that do not generate income." Gray Test. at 5. Their exempt status is essential. Proposals to limit or eliminate that tax exemption thus are potentially harmful to the provision of health care services to the public and therefore not in the public interest. We urge the Subcommittee not to raise questions concerning the tax exempt status of nonprofit hospitals.

II. HOSPITAL FINANCES, INCOME PRODUCING ACTIVITIES AND THE UBIT.

The income producing activities of nonprofit organizations are essential to meeting their growing financial burdens. The UBIT rules and the relatedness standard they incorporate provide a well-proven method for taxing those activities and should be retained.

A. The Changing Face of Hospital Finance.

America's hospitals are facing a serious financial crisis -- a fact about which most of the witnesses, including witnesses for small business, agreed. Financial pressures have increased due to rising costs, large cuts in the growth of the Medicare budget, changes in reimbursement policies, and changes in the tax laws that diminish incentives for charitable giving. One of the witnesses for small business at the UBIT hearings, the Textile Rental Services Association of America ("TRSA"), concurred that "decreased voluntary contributions and increased restrictions on federal reimbursement" have placed "a severe financial strain on many nonprofit hospitals." TRSA Test. at 1.

New York Hospital, like other nonprofit hospitals in New York State and across the country, has experienced this financial strain. Over time, the Hospital's reliance on fee-based income has increased: The percentage of New York Hospital's total revenue* from patient care increased from 71 percent of its revenues in 1981 to 86 percent in 1985. Total revenue from all sources only increased by an average of approximately 4.9 percent annually over the same period. During this time, the Hospital's total expenses increased at an average rate of 12 percent annually. These figures are comparable to other hospitals in New York City and the state. Total expenses for hospitals in New York City increased an average of 12.5 percent per year between 1978 and 1984; in New York State, the average increase was 13.5 percent. Hospital Education and Research Fund, New York State Health Care Profile at 49-50. Between 66 and 82 percent of New York State hospitals reported operating losses between 1981 and 1985; between 85 and 94 percent of voluntary hospitals in New York City reported losses during the same period. Hospital Association of New York State, 1985 Fiscal Pressures Survey Preliminary Report.

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* "Total revenue" represents the total of the Hospital's sources of funds, including gross rental income and gross income from sales of securities and other assets by the Hospital. "Total expenses" do not include expenses which required no cash outlay by the Hospital for the year, such as depreciation expense.

B. The Role of Unrelated Business Income.

These financial pressures have caused hospitals to seek new revenues from their income-producing activities. Hospitals, unlike some other areas of the nonprofit sector, have relied on fee-based income for many years. As New York Hospital's experience shows, that reliance on patient care revenues has increased dramatically.

A small but increasingly important portion of some hospitals' income-producing activities may not be related to their charitable purpose. The Internal Revenue Code (the "Code") section 511 imposes a tax at corporate rates on "unrelated business taxable income" of exempt organizations. Wisely, Congress chose long ago to tax such income, rather than to flatly bar tax exempt organizations from unrelated activities, and so permitted these organizations to make their own decisions as to whether such activities made economic sense. This relatedness standard accurately reflects the need for nonprofit hospitals to maintain the tax-exemption for those activities that are related to these health care functions.

Several exemptions are provided in the Code and in Treasury regulations for specific business activities. Exclusions apply to income where (i) substantially all of the work connected with the activity is performed for the organization without compensation; (ii) substantially all of the merchandise sold is received as contributions; or (iii) the business is carried on primarily for the convenience of the organization's members, students, patients, officers, or employees. There are several other exceptions. If no exemption is applicable, any "unrelated trade or business" which is regularly carried on by the exempt organization in a commercial manner potentially will be subject to the UBIT.

Although no statutory framework can be totally unambiguous, the concept of this unrelated business income is well developed and articulable. Contrary to the contentions of some witnesses at the hearings, judicial and regulatory authorities developed over thirty-five years provide taxpayers with guidance in even very complex areas. For example:

- Income from patient care is of course considered to be income related to the performance of a hospital's exempt function.
- The IRS has ruled that certain business activities such as a hospital gift shop, a parking lot for patients, visitors or employees, television rentals, and a cafeteria or coffee shop for visitors or employees, are related to a hospital's exempt function, because they encourage patient recovery or increase efficiency of employees.
- Hearing aids and pharmaceutical supplies may be sold to patients because this activity contributes importantly to the organization's purpose of promoting health.
- A hospital may use its facilities to read and diagnose electrocardiograms for hospitals that lack facilities to perform this service.
- Income from research activity is specifically exempt from the UBIT in the case of a hospital or university, regardless of for whom the research is undertaken.
- Hospitals may provide certain services to small exempt hospitals (with 100 or fewer patients) at cost without incurring unrelated income tax. These services include clinical and laboratory services, food, industrial engineering, warehousing and a number of clerical services. These exemptions produce no anticompetitive advantage, because such services must be provided at cost in order to qualify for the UBIT exemption.

Other income-producing activities of hospitals have been declared unrelated and therefore taxable, however. For example:

- Pharmaceutical sales and testing services performed for nonpatients of a hospital probably will not be exempt from the UBIT unless compelling facts indicate that it would be detrimental to the health of the nonpatients if they were referred elsewhere.

- Hospitals generally may not provide laundry services to other exempt hospitals without triggering the UBIT.

- A hospital is required to pay UBIT on income from the commercial operation of a health club.

- Hospitals also must pay UBIT on income from sponsoring and administering insurance for its members and employees, or otherwise providing insurance generally of a type provided by commercial insurance companies.

- Advertising net income raises UBIT concerns, and is permitted under only a very limited set of circumstances.

The detailed guidance provided by the UBIT is shown by its treatment of rental income. A hospital may use debt-financed real property for such related activities as providing residences for its employees, short-term living quarters for patients and their visitors, or office space for physicians whose office functions as the hospital's outpatient ward. If an exempt hospital leases personal property, however, this income will be unrelated business income.

In light of the clear guidance the UBIT rules provide, complaints about unfair competition from small businesses are unpersuasive. Many of the unrelated business activities about which they complain, such as sales of testing services or pharmaceuticals to nonpatients, are already subject to the UBIT. For example, in its testimony before the Subcommittee, the American Clinical Laboratory Association ("ACLA") admitted that the IRS has determined that tests by hospitals on referred specimens from private office patients of the hospital's staff physicians and of medical clinics not connected with the hospital are unrelated and therefore taxable. ACLA Test. at 3. If some hospitals are not paying taxes, the fault is a matter of inadequate information or lax enforcement, rather than a defect in the UBIT. Other objections to hospitals' income-producing activities, such as the price at which they resell drugs, are properly a question of fair trade laws, not taxation, as the testimony of the Health Industry Distributors Association ("HIDA") admitted. HIDA Test. at 7.

The UBIT is well-developed and workable. It allows nonprofit organizations to raise money in the most efficient manner while assuring that their unrelated business activities are taxed in the same manner as for-profit concerns.

III. PROPOSALS TO REVISE THE UBIT SHOULD BE RESISTED.

The Subcommittee heard proposals from a number of witnesses to overhaul the UBIT. Proposals that would ban nonprofit hospitals from certain income-producing activities or limit their use of subsidiaries should be flatly rejected. Such prohibitions would violate the flexibility inherent in the UBIT. Moreover, there are two very powerful limitations on the ability of an exempt organization to engage in unrelated activities: the imposition of a tax on such income and the possible loss of exempt status. If the UBIT is properly enforced, many of the complaints raised by small businesses will be resolved.

The most comprehensive suggestions offered to the Subcommittee come from the Department of the Treasury ("Treasury"). These suggestions were intended only "as a starting point for further debate" (Treasury Test. at 2) and hence are often vaguely described. While some suggestions have merit, certain specific proposals could cause harm, as the following comments indicate:

Suggestion 1. Retain the current "substantially related" standard, but improve enforcement and compliance.

Treasury's first proposal is also its most sound. As the previous discussion shows, the relatedness test provides a firm foundation for the UBIT. Treasury concurs that "tax-exemption should appropriately extend to that collection of activities that are substantially or integrally related to the organization's exempt functions." Treasury Test. at 20. Other tests, such as whether the activity is "commercial" in nature or whether it competes with for-profit business, are at least as subjective as the relatedness test and may involve even more difficult administrative judgments. Moreover, such tests shift the focus from the tax-exempt organization's need to raise income, to the operations of other firms over which the tax-exempt organization has no control.

Treasury's call for improved enforcement by the IRS and more detailed compliance also have merit, provided such measures do not become burdensome and do not intimidate nonprofit organizations. Improving enforcement and providing better guidance to nonprofit entities may eliminate many misperceptions about the UBIT that were expressed to the Subcommittee by small business. New York Hospital notes that the IRS has announced a taxpayer compliance measurement program of nonprofit organizations, to determine their compliance with the UBIT. Formal changes in IRS procedures should wait until that program is completed. See p. 10, infra.

Suggestion 2. Reexamine the exceptions for businesses operated by volunteers and businesses conducted for the convenience of students, patients and others.

The UBIT exemption provided for income from volunteer work and donated merchandise is a logical extension of the rule that public contributions to an exempt organization are not income to the organization. At least one commentator has recognized that "the expansion of such enterprises is limited by the willingness of individuals to contribute time or goods." The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations, 81 Harv. L. Rev. 1280, 1282 (1968). Often, such volunteer activities are the only way in which persons of limited means are able to make charitable contributions. Generally, the income that is generated through volunteers is income raised in connection with fundraising activities which motivate "customers" of the exempt organization for reasons other than the quality or price of the product or service provided. This exemption thus does not result in a competitive advantage accruing to tax exempt organizations.

Where services are provided for the convenience of hospital staff, students, physicians, and patients, it is generally the case that these services are not furnished primarily because they produce revenue. For example, conveniences such as an employee cafeteria, vending machines, a pharmacy, staff residences, and temporary patient housing provide a vital service to a hospital's patients and increase its efficiency. In many ways, such services have become more than just "conveniences." They have become necessary to the proper functioning of a modern teaching hospital. There is no evidence to indicate whether or not the private sector would be willing to assume these services at their current rate of return. Even if some services would be exempt from the UBIT because they are, in fact, related to the hospital's charitable purpose, the Subcommittee should be reluctant to change this rule when there is no evidence to suggest that it currently is being misused by exempt organizations.

Correctly, the Treasury recognizes that both of these suggestions require additional information, which may be forthcoming when the IRS taxpayer compliance measurement program is completed.

Suggestion 3. Clarify the allocation rules concerning related and unrelated expenses.

Current regulations require that, where a nonprofit organization conducts both exempt and unrelated activities, the organization must allocate expenses, depreciation and overhead between the two uses on a reasonable basis. The allocation rule enunciated in *Rensselaer Polytechnic Institute v. Commissioner,* 732 F.2d 1058 (2d Cir. 1984) is appropriate, contrary to Treasury's view. *See* Treasury Test. at 23-25. In that case, the appeals court upheld the taxpayer's contention that the fixed cost of a field house should be allocated on the basis of a comparison of the hours per week used for exempt and nonexempt purposes: *e.g.*, if half of the hours of use were dedicated to non-exempt purposes, half the fixed costs would be allocated to that use.

This approach recognizes that the actual use of a facility should determine how its costs are allocated. This allocation rule permits many nonprofit entities, including hospitals, to acquire expensive equipment and facilities, a portion of which must be devoted to unrelated activities to recover their costs.

The position taken by the IRS in court and by Treasury in its testimony, is that such expenses should be allocated on the basis of the hours used for unrelated business activities compared to the total time available for use, which would allow a smaller deduction against the unrelated business income. There is no rational reason why fixed expenses are any more or less attributable to the unrelated uses or to the related uses of a split-time facility. Allocations of fixed expenses should be based upon the actual use of such facilities. Treasury's suggestion would make the financing of such facilities much more difficult for nonprofit organizations and, in many cases, prohibitively expensive. Indeed, it might encourage nonprofit entities to seek even greater use of the facilities for commercial purposes, to increase the proportion of the deduction attributable to unrelated uses. Congress should reject Treasury's misguided call to revise the allocation rules.

Suggestion 4. Consider aggregating the activities of a nonprofit organization and its subsidiaries to determine the nonprofit organization's purpose.

Nonprofit organizations, like other economic entities, organize subsidiaries for a variety of reasons, many of which have no relation to the tax laws. For example, a nonprofit organization may organize a subsidiary to limit liability for certain activities, to enjoy the benefits which may arise from separate management systems, or, as CHA pointed out in its testimony, to segregate activities that are subject to unique regulations. CHA Test. at 16. CHA also noted that nonprofit entities may organize for-profit subsidiaries specifically to conduct useful activities which, if they were conducted by the nonprofit entity itself, would produce unrelated income that could jeopardize the nonprofit entity's tax exemption. *Id*. In short, non-profit groups organize subsidiaries when, in their view, it produces the most efficient result.

Treasury has suggested that the operations of such subsidiaries should be considered in determining whether the nonprofit parent's primary purpose is in fact tax exempt. This suggestion would impair nonprofit organizations' ability to organize their affairs in the most economically efficient manner.

Moreover, Treasury's position is inconsistent with its subsequent admission that "the exemption for passive investment income may appropriately encourage exempt organizations to avoid deeper commercial involvements and the potential distractions and conflicts they present." Treasury Test. at 30. In order for an investment in a taxable subsidiary to be considered an investment, the charity must be careful to avoid becoming involved in the day-to-day operations of the subsidiary. As stated earlier, p. 5, *supra*, the imposition of the UBIT and the risk of loss of tax exempt status deter exempt organizations from becoming involved in commercial activities. These sanctions are powerful restraints on the improper use of subsidiaries. Current law is adequate to prevent abuse, and in the absence of evidence of abuse, Treasury's suggestion should be rejected.

Treasury also suggested changing the definition of a "controlled" subsidiary. Under current law, if the subsidiary of a nonprofit organization is "controlled" by the parent, income in the form of interest, rents and royalties from the subsidiary may be taxable as unrelated business income to the parent. A "controlled" organization exists if an exempt organization owns 80 percent of more of the total combined voting power of all classes of voting stock and 80 percent of the total shares of all other classes.

Treasury proposes to reduce the controlling level of stock to 50 percent. This proposal also should be rejected because it would virtually require nonprofit entities to become minority shareholders in any subsidiary they organize, to avoid inadvertently becoming subject to tax. Such an interference with the freedom of nonprofit entities to organize their activities in the most efficient manner is unacceptable, especially in the absence of evidence of abuse. The concerns which Treasury has identified could be eliminated by more delicate legislative changes.

Suggestion 5. Retain the current exclusion for passive income, but narrow the definition of excluded royalty income.

Correctly, Treasury recommends retention of the current tax exemption for passive income -- dividends, interest, annuities, royalties and rents -- earned by 501(c)(3) public charities like New York Hospital. Such income is an essential component of charitable operations. Moreover, the current tax exemption reinforces the freedom of 501(c)(3) organizations to make investments in the most efficient manner.

Treasury's suggestion to narrow the definition of tax exempt royalties is more troublesome. Treasury suggests excluding from the definition of exempt royalty income amounts measured by net profits or amounts received by exploiting the nonprofit organizations' goodwill. Here, again, Treasury provides no evidence to support its suggestion. Until such evidence is gathered, there is no reason to change the current definition.

Suggestion 6. Revise the definition of exempt research and examine requirements for public dissemination of the results of such research.

As a teaching and research hospital, New York Hospital is concerned that any call for changes in the exemption for income from research activities be carefully studied. The contributions to the public health made in the laboratories and libraries of research hospitals are at least as important as the medicine practiced in hospital wards and operating rooms. Often, the practice of medicine and research cannot be separated. The health of the nation would be ill-served if the laws that promote these research activities were altered.

Income derived from research by federal or state governments and by colleges, universities and hospitals is excluded from the UBIT. I.R.C. § 512 (b)(8). For the purposes of this exemption, the Service generally defines "research" as it is used in the context of tax-exempt "scientific" research. "[T]he issue is usually whether the activity is being carried on as an incident to commercial or industrial operations; if it is, it will almost assuredly be regarded by the IRS as an unrelated trade or business." Hopkins at 779.

We believe that this limitation, which is incorporated in the regulations, satisfactorily prevents tax-exempt organizations from misusing the research exemption. Attempts to tighten the current exemption would likely have a chilling effect on the research activities of nonprofit organizations, which might reduce their research rather than risk becoming subject to taxation inadvertently. At a time when the nation's investment in basic and applied research is diminishing, the federal government would send the wrong signal if it restricted the research exemption. Perhaps for this reason, Treasury has advanced no specific proposals to change the research exemption. It is more appropriate to permit nonprofit entities to develop their own protocols to determine what research activities are proper and how to diffuse the benefits of that research to the public.

Suggestion 7: Examine the use of joint ventures by nonprofit entities and consider subjecting partnership income to the UBIT.

As noted before, one of the advantages of the current UBIT is its flexibility: the UBIT permits nonprofit economics to adapt as times change, and does not lock nonprofit organizations into ossified methods of operating. Nevertheless, Treasury is concerned about the perceived increase in the use of joint ventures by nonprofit organizations as a new source of finances for them. According to its testimony, the specific concern is that an exempt organization conducting an exempt activity in partnership with a taxable organization may violate the basic requirement that its earnings may not inure to the benefit of a private party. Treasury Test. at 40. Treasury proposes to monitor the extent of the use of such partnerships; where the inurement doctrine is violated, Treasury proposes that income from such partnerships be subject to the UBIT.

Joint ventures represent a novel experiment in nonprofit health care that should be encouraged. In its testimony, the American Hospital Association ("AHA") presented examples of the contributions such joint ventures make: they create critical ties to other health care delivery and financing organizations and to physicians; they maximize efficiency, by permitting hospitals to invest in the purchase of expensive diagnostic equipment with other users; and they promote patient care such as when they encourage physicians to locate their offices near the hospital. AHA Test. at 8-9.

Perhaps most important, joint ventures may provide a crucial means to fill the charitable contribution gap by leveraging new sources of private funds. Increased pressures to maximize profits and to avoid takeover attempts have caused significant reductions in corporate giving, the New York Times reports. New York Times, July 8, 1987 at 1, col. 3. Several commentators have recognized that commercial firms are often reluctant to lend to charities. See Note, The Participation of Charities in Limited Partnerships, 93 Yale L.J. 1355, 1359 (1984). Joint ventures permit new access to private dollars. The commentators also note that in a joint venture "[t]he charity, as general partner, will have sole control over the use of the invested funds and can therefore ensure that they will be used for the purpose to which the organization is dedicated." Id. at 1360 (footnote omitted).

Treasury's discussion expressed concerns, not about abuses of the UBIT, but rather about two entirely different issues raised by joint ventures: the problem of private inurement and the requirement that exempt organizations operate exclusively for exempt purposes. When an exempt organization is a general or limited partner in a partnership with non-exempt partners, the partnership must serve a charitable purpose. Questions about the implications of joint ventures on the private inurement doctrine go far beyond the scope of the present inquiry into the function of the UBIT.

Treasury's discussion may leave the misimpression that income from joint ventures currently is not subject to the UBIT. Such is the not the case. If the partnership conducts a trade or business, even if there is no private inurement problem and the operational test is satisfied, its income may be subject to the UBIT, as specifically provided for by the Code, if it is unrelated to the organization's exempt purpose.

So long as it does not inhibit the development of joint ventures, Treasury's proposal to monitor their use is acceptable.

We also agree with the recommendation of the Department of the Treasury that it may be "more appropriate" to impose the UBIT on partnership income than to take away an organization's exempt status when it fails to satisfy the private inurement and operational tests. Treasury Test. at 40. Any broad restrictions on the use of joint ventures, however, should be resisted.

IV. STRUCTURAL CHANGES IN THE UBIT SHOULD BE AVOIDED UNTIL MORE DETAILED INFORMATON IS AVAILABLE.

Congress should not undertake structural changes in the UBIT until it obtains more complete information. The hearings made very clear that little reliable information is available about the income producing activities of nonprofit organizations. The anecdotal information that is available is insufficient as a basis for public policy.

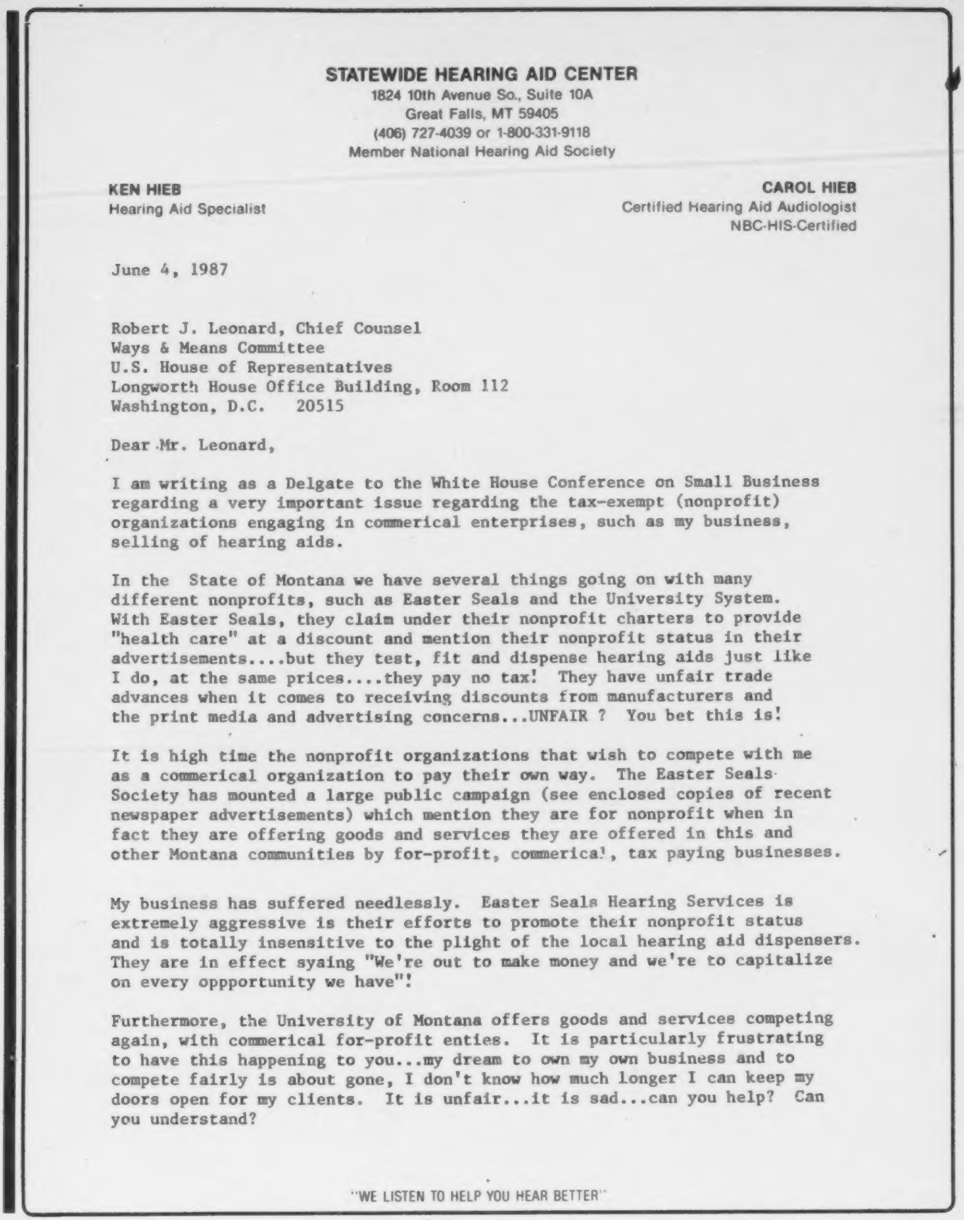
One source of useful information is tax returns that report nonprofit organizations' unrelated business income. The IRS recently announced that, beginning in FY 1988, it will conduct a taxpayer compliance measurement program that will involve audits of the unrelated business income tax returns of 3,000 randomly chosen nonprofit organizations. IRS Test. at 4. The information provided by that study may answer many of the questions raised during the hearings.

Structural changes to the UBIT rules made in the absence of full information could cause substantial harm to nonprofit organizations' ability to serve the public. Rather than initiate such premature changes, Congress should encourage the IRS to complete its taxpayer compliance measurement program and to provide better guidance on the application of the UBIT to nonprofit organizations.

Conclusion

The UBIT is a unique, well-developed tool, which properly taxes unrelated business income of nonprofit organizations while permitting them to experiment with new sources of income and new forms of organization. This experimentation is vitally necessary today, as hospitals nationwide face increasing financial pressures. Many of these changes have been brought about by the federal government, whose insistence on strict cost control and cutbacks in health care financing are responsible in substantial part for hospitals' acute need for new sources of income. The government should not penalize nonprofit hospitals for conducting experiments in hospital finance and structure that the government's own policies have largely necessitated.

The UBIT works admirably well. Many of the complaints lodged by the for-profit sector relate to a handful of anecdotes and incidents where exempt organizations were unaware of the rules already in place. Better enforcement and improved guidance, coupled with the information to be gained by the IRS taxpayer compliance measurement program, may resolve these remaining problems with the UBIT. Such moderate means should be used first before misguided "reforms" damage the delicate structure that supports America's health care system.



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Member National Hearing Aid Society

KEN HIEB
Hearing Aid Specialist

CAROL HIEB
Certified Hearing Aid Audiologist
NBC-HIS-Certified

June 4, 1987

Robert J. Leonard, Chief Counsel
Ways & Means Committee
U.S. House of Representatives
Longworth House Office Building, Room 112
Washington, D.C. 20515

Dear Mr. Leonard,

I am writing as a Delgate to the White House Conference on Small Business regarding a very important issue regarding the tax-exempt (nonprofit) organizations engaging in commerical enterprises, such as my business, selling of hearing aids.

In the State of Montana we have several things going on with many different nonprofits, such as Easter Seals and the University System. With Easter Seals, they claim under their nonprofit charters to provide "health care" at a discount and mention their nonprofit status in their advertisements....but they test, fit and dispense hearing aids just like I do, at the same prices....they pay no tax! They have unfair trade advances when it comes to receiving discounts from manufacturers and the print media and advertising concerns...UNFAIR ? You bet this is!

It is high time the nonprofit organizations that wish to compete with me as a commerical organization to pay their own way. The Easter Seals Society has mounted a large public campaign (see enclosed copies of recent newspaper advertisements) which mention they are for nonprofit when in fact they are offering goods and services they are offered in this and other Montana communities by for-profit, commerical, tax paying businesses.

My business has suffered needlessly. Easter Seals Hearing Services is extremely aggressive is their efforts to promote their nonprofit status and is totally insensitive to the plight of the local hearing aid dispensers. They are in effect syaing "We're out to make money and we're to capitalize on every oppportunity we have"!

Furthermore, the University of Montana offers goods and services competing again, with commerical for-profit enties. It is particularly frustrating to have this happening to you...my dream to own my own business and to compete fairly is about gone, I don't know how much longer I can keep my doors open for my clients. It is unfair...it is sad...can you help? Can you understand?

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June 4, 1987
Page 2

Mr. Robert Leonard

As a member of the National Hearing Society, I am licensed and Certified in my profession and I am proud to serve the hearing impaired public. I was among over 1800 delgates to the Conference held in Washington D.C. last August. Our number three concern was this issue of unfair competition from tax-exempt organizations. I learned of many other types of businesses in this country undergoing the same type of pressures because of a non-profit has decided to actively engage in sales -- not only in hearing aids but also computers, clothing, audio-visual equipment, laboratory services, travel services and medical health services, etc.

It is imperative for the Ways & Means Committee listen to this plight of the American Business person. We celebrate our 200th birthday this year of the Constitution of this United States...we should be thankful and rejoice that our forefathers took such mighty action...somehow I don't feel rejoiceful in our free enterprise system...you must listen to the pleas of the small business concerns. Our voices must be heard loud and clear, we must find a way to unburden the small businesses today from this unfair competition by non-profits or perhaps we will not have a flourishing business world tommorrow!

I hope that you will find it possible to give this matter your utmost attention. It is vital that we have help from each other to help "cure" and not just to "smooth over" the symptoms of an ailing business community. I speak not just for myself but for the thousands of others who are in desperate need.

Thank you for your support.

Sincerely,

Carol J. Hieb

Carol J. Hieb
White House Delgate
Small Business Owner

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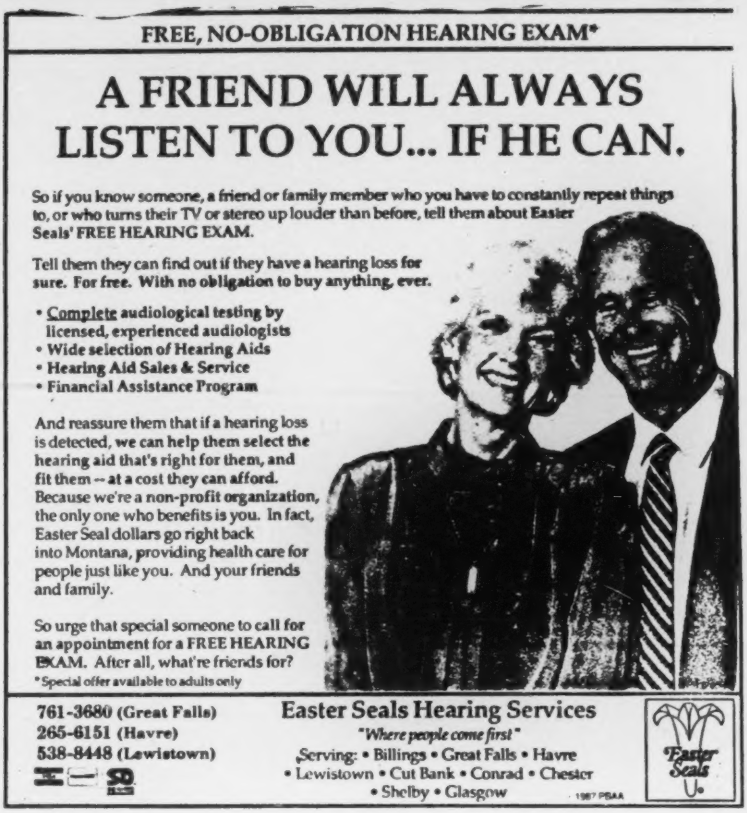

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Tell them they can find out if they have a hearing loss for sure. For free. With no obligation to buy anything, ever.

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And reassure them that if a hearing loss is detected, we can help them select the hearing aid that's right for them, and fit them -- at a cost they can afford. Because we're a non-profit organization, the only one who benefits is you. In fact, Easter Seal dollars go right back into Montana, providing health care for people just like you. And your friends and family.

So urge that special someone to call for an appointment for a FREE HEARING EXAM. After all, what're friends for?

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Special Report

White House Conference on Small Business

Hearing aid specialists played a prominent role in shaping the course of events at the recently completed 1986 White House Conference on Small Business. Held in Washington, D.C., on August 17-21, this event was the culmination of a year-long process which included 55 state conferences and the participation of several hundred thousand small business people.

The preliminary state meetings served to elect delegates to the national conference and to select specific issues and problems for possible inclusion in a comprehensive small business legislative agenda.

Through the state conferences, Congressional and Presidential appointments, a total of 1,823 delegates were selected to participate in the White House Conference. Of those 1,823 delegates, an astounding eighteen were representatives of the hearing instrument specialist profession.

The principal product of the conference was a final list of 60 suggestions that the delegates adopted in four days of spirited debate, lobbying and voting. These recommendations, culled from more than 2,000 advanced at the state meetings, will go to the White House and Congress for consideration.

The top three items on the final recommendation agenda were: 1) Resolution of the liability insurance crisis; 2) A halt to government-mandated employee benefits; and 3) Steps to prevent nonprofit organizations and government from engaging in activities that compete unfairly with small business.

Participants from the hearing instrument field joined delegates from such divergent businesses as analytical testing labs and travel agents in advocating the need for fair competition by controlling the commercial activities of nonprofit entities. Delegates favoring resolution of the unfair competition dilemma were organized through the efforts of the Business Coalition for Fair Competition (BCFC). NHAS is a founding member of BCFC.

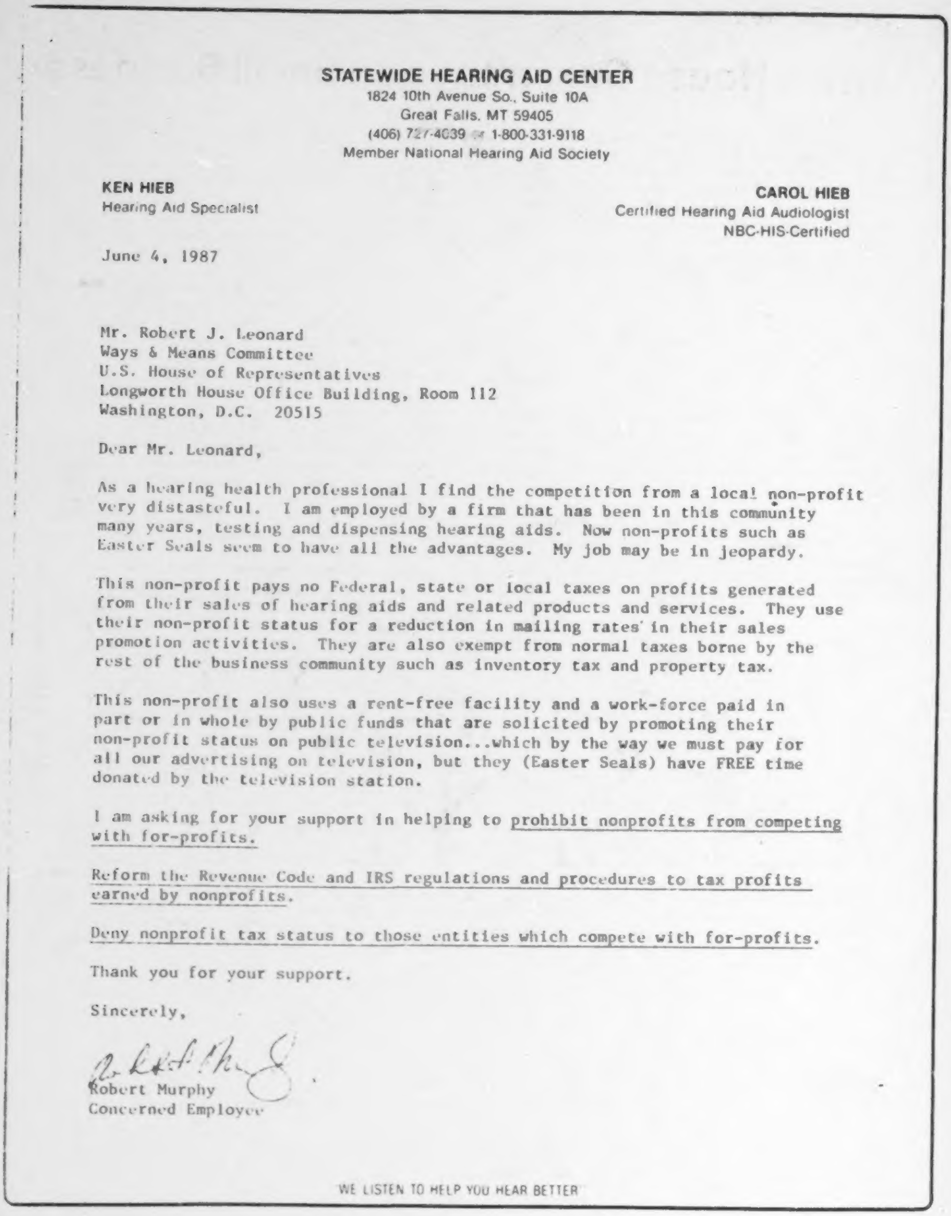
Featured speakers at the White House Conference on Small Business included Donald T. Regan, White House Chief of Staff; William E. Brock, Secretary of Labor; William J. Bennett, Secretary of Education; Elizabeth Dole, Secretary of Transportation; Representative Jack Kemp (R-NY) and Senator Robert Dole (R-KS).

Senator Dole's address to the closing session of the conference on August 21st was particularly noteworthy. In his comments, Senator Dole observed:

> **"I also happen to believe that you ought to be protected from so-called charitable groups that are in competition with those who are trying to make a profit. And I like Blue Cross and I like Blue Shield, but, as you know, in the tax bill we took a small step — we took a small step to say that nonprofits who make a profit ought to be treated like profits when it comes to the tax code. And they shouldn't be competing with others."**

NHAS members serving as delegates at the White House Conference were (left to right): Robin Holm (WA), W.F.S. Hopmeier (MO), Paul Woodard (IA), Richard Schneider (CA), Floyd Loupot (CA), Richard Davila (TX), Edmund Wolfe (MO), Carol Hieb (MT), Alice Gallagher (CA), Dick Durbin (TX), John H. Young, Jr. (SC), Gregory Sommer (MO), Herbert Gorlin (FL), Gerald Young (ID), William Fowler (MT), and Layne Dike (ID). Attending as an observer was NHAS Government Relations Director James Lovell, top, far right.

Not pictured are delegation members Paul Gravett (OR) and Jim Wilson (TX), and observers Ray O. Bedsaul (NC) and Ambrose Dreiling (TX).



STATEWIDE HEARING AID CENTER
1824 10th Avenue So., Suite 10A
Great Falls, MT 59405
(406) 727-4039 or 1-800-331-9118
Member National Hearing Aid Society

KEN HIEB
Hearing Aid Specialist

CAROL HIEB
Certified Hearing Aid Audiologist
NBC-HIS-Certified

June 4, 1987

Mr. Robert J. Leonard
Ways & Means Committee
U.S. House of Representatives
Longworth House Office Building, Room 112
Washington, D.C. 20515

Dear Mr. Leonard,

As a hearing health professional I find the competition from a local non-profit very distasteful. I am employed by a firm that has been in this community many years, testing and dispensing hearing aids. Now non-profits such as Easter Seals seem to have all the advantages. My job may be in jeopardy.

This non-profit pays no Federal, state or local taxes on profits generated from their sales of hearing aids and related products and services. They use their non-profit status for a reduction in mailing rates in their sales promotion activities. They are also exempt from normal taxes borne by the rest of the business community such as inventory tax and property tax.

This non-profit also uses a rent-free facility and a work-force paid in part or in whole by public funds that are solicited by promoting their non-profit status on public television...which by the way we must pay for all our advertising on television, but they (Easter Seals) have FREE time donated by the television station.

I am asking for your support in helping to prohibit nonprofits from competing with for-profits.

Reform the Revenue Code and IRS regulations and procedures to tax profits earned by nonprofits.

Deny nonprofit tax status to those entities which compete with for-profits.

Thank you for your support.

Sincerely,

Robert Murphy
Concerned Employee

WE LISTEN TO HELP YOU HEAR BETTER

FACT SHEET

UNFAIR COMPETITION FROM NONPROFIT ENTITIES

DEFINING THE PROBLEM & EXPLORING SOLUTIONS

DEFINITION OF THE PROBLEM

Competition between commercial for-profit firms and tax-exempt organizations is increasing. Markets traditionally served by small, for-profit firms are now being offered products and services produced by tax-exempt, not-for-profit entities.

While the public perception of tax-exempt organizations is that they derive most of their income from charitable contributions and tax revenues, according to reports filed with the Internal Revenue Service(IRS), they derive 76 percent of their income from sales. In contrast, their gifts and dues income represents only 23 percent of their income. Of course, some of the sales may be charges for such things as publications,that are clearly part of the nonprofit's charitable, educational or cultural mission serving the needy, the sick and disabled or association members. However, the competition posed by many of these sales activities is unfair and should be dealt with.

BASIC QUESTION

Q. What is "unfair"?

A. Products and services which are offered by a nonprofit in direct competition with products and services offered by a small, for-profit business provide the basis for the charge of "unfair" competition. The unfair aspects are:

1.) The nonprofit may pay no Federal, state or local taxes on profits generated from sales of products and services.
2.) The nonprofit may be tax-supported.
3.) The nonprofit may use nonprofit mailing rates in its sales promotion activities.
4.) The nonprofit may be exempt from normal taxes borne by most businesses such as sales tax, inventory tax and property tax.
5.) The nonprofit may operate using rent-free facilities and a work-force paid in part or in whole by public funds.

SOLUTIONS

Prohibit nonprofits from competing with for-profits.

Reform the Revenue Code and IRS regulations and procedures to tax profits earned by nonprofits.

Deny nonprofit tax status to those entities which compete with for-profits.

THE ATTORNEY GENERAL
OF TEXAS

JIM MATTOX
ATTORNEY GENERAL

July 29, 1987

Mr. Robert J. Leonard
Chief Counsel, Committee on Ways and Means
U.S. House of Representatives
Room 1102, Longworth House Office Building
Washington, D. C. 20515

RE: Unrelated Business Income of tax exempt organizations

Dear Mr. Leonard:

Pursuant to the announcement of the Honorable J. J. Pickle, Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U. S. House of Representatives, that the Subcommittee will review the unrelated business income tax, these comments are submitted. As a former Congressman and now Texas Attorney General, I am submitting this statement to encourage improved regulation of charities at both the federal and state level and to suggest some methods for achieving reform.

For purposes of this comment, the term "charitable trust" includes all organizations that are classed under Section 501(c)(3) of the Internal Revenue Code. Where necessary, private foundations, as determined under the Internal Revenue Code, are distinguished from public charities.

The Public Interest in Charitable Trusts

It is impossible to accurately state either the number of charitable trusts which exist or the value of the assets they control. It is quite obvious, however, that the ranks and resources of charitable trusts have swelled. Unfortunately, the public has not reaped the full benefit of this expansion. All too often, charitable trusts, which are supposed to serve the public, are used for personal enrichment.

Nationally, the press has reported abuses in the application of charitable funds by a major crippled childrens organization, television evangelists and self-proclaimed "super-patriots". The national news reports are only the tip of the iceberg. Many abuses are reported or identified only locally. See Exhibit 1 in Committee file.

The abuses of charitable trusts have been, unfortunately, fostered by the growing chasm between the resources of state and federal regulators and the power of charitable trusts. At the state level, the state Attorneys General have generally received woefully insufficient funds to properly protect the public's interest in charitable trusts. For example, the assets held by private foundations in Texas increased approximately 600 % between 1968 and 1984 while the Charitable Trust staff of the Texas Attorney General was reduced from three attorneys to two attorneys.

Like other states, Texas has, as a practical matter, relied on the Internal Revenue Service to police charitable trusts. It is doubtful that the U. S. Congress ever intended the federal tax collection agency to supplant the states as the tool for enforcing charitable trusts.

The Role of the State Attorney General

Under Texas law, the state Attorney General is charged with the duty to protect and preserve charitable assets on behalf of the public. Because charity by definition is intended to benefit the public rather than particular individuals, the early legal principle developed that the Attorney General would be vested with the power to investigate and enforce charitable trusts on behalf of the community. A corollary to this principle also developed which held that members of the general public lacked standing to sue charities even if they belonged to the class of potential beneficiaries. This corollary developed to protect charities from otherwise numerous lawsuits which might be filed by members of the public.

In current legal thought, charitable trusts include not only pure trusts, but also certain types of non-profit corporations. However, not all non-profit corporations are established for charitable purposes. Non-profit corporations may be established either for the benefit of the public or for the benefit of its members. The first class of non-profits are termed "public benefit non-profit corporations" and include all organizations falling under §501(c)(3) of the Internal Revenue Code. The second class are termed "mutual benefit non-profit corporations" and generally include organizations which are not classified under §501(c)(3). Mutual benefit, non-profit corporations include organizations which only serve members and other organizations which produce some, but not exclusively, public benefit.

The Attorney General is charged with protecting the assets of mutual benefit non-profit corporations only to the extent that such organizations solicit or receive donations for charitable purposes. Membership dues are not considered charitable assets since they were not intended for charitable purposes when paid.

The directors and trustees of charitable trusts have a legal duty to apply charitable resources for the purposes stated in their governing instrument. This duty is owed to the public who, in effect, are the stockholders. Thus, the state Attorney General enforces the rights of the public and makes the directors and trustees accountable for their conduct.

Charitable trusts (including non-profit corporations and foundations created for charitable purposes) are distinguished from business organizations by the dedication of their resources to purposes beneficial to the public. Consequently, the directors and trustees are fiduciaries to the public and must ensure that the resources of the charitable trust are used to benefit the public and to protect such resources from waste mismanagement, or misapplication.[1]

Because of the public purpose of trusts, the attorney general of each state, as representative of the public, is obligated under law to protect and preserve the public interest in charitable trusts and is usually a necessary party to any suit affecting the public interest in charity. The attorney general may sue on his own motion or on the relation of a member of the general public.[2]

While the number and resources of charitable trusts have multiplied at a tremendous rate, the resources devoted to the supervision of charitable trusts has remained generally constant. As a result, staffs at the state level are overwhelmed with reports of abuses and must select only the most blatant abuses for remedial action. Many reported cases of misconduct simply are not acted upon due to lack of staff. Further, there are few ongoing programs in the states to routinely monitor charitable trusts.

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[1] Restatement (Second) of Trusts § 348 (1977).

[2] Restatement (Second) of Trusts § 390 (1977).

The problem of regulating charitable trusts is further complicated by the impact of the Internal Revenue Code. Each state, including Texas, has enacted laws designed to ensure that the non-profit corporations of that state qualify for tax exempt, tax deductible status. Although the definition of charity is a matter of state law, the states uniformly declare that entities exempt from federal taxes are exempt from state taxes. In effect, the states have determined to rely on the IRS to weed out undeserving organizations. This not the role the U. S. Congress intended.

The Problem of Unrelated Business Income

The responsibility of trustees to the public is further clouded by the ownership of profit-making subsidiaries by charitable trusts. As business owners, the trustees have a responsibility to maximize profit. This can conflict with a trustees duty to maximize the public benefit of the charitable trust.

Additionally, the creation or acquisition of business enterprises by charitable trusts has increased the burden on an already inundated regulatory system. Two recent investigations by the office of the Texas Attorney General illustrate the increasing complication in the field of charitable trust regulation.

In the course of conducting an investigation of a major medical hospital located in Houston, our staff determined that the hospital was on the verge of a major reorganization. Under the proposed reorganization, the tax-exempt, tax-deductible hospital would become a holding company. In turn this "hospital" was to have three subsidiary holding companies. One subsidiary holding company was to own several tax-exempt operating corporations including the hospital. Another of the subsidiary holding companies was to own stock in both tax exempt and non tax exempt entities. The remaining subsidiary holding company was to own stock in corporations which were purely established for profit. These operating corporations included a garage facility, a restaurant, a conference center, and an athletic club. Each of these corporations was capitalized with assets that were either donated to the hospital or funded with the assets of the charitable trust. In effect, assets which were intended to be used to benefit the public would be used, instead, to compete with small businesses.

Currently, we are investigating the ownership of a for profit laundry facility by a public-benefit, non-profit corporation. From our investigation, it appears that the corporation, which is classified as a public charity by the IRS, has lost over $5 million in the operation of the laundry in the last three years. Because of the loss of resources that the operation of the laundry has caused, a significant amount of resources has been drained away from the primary purpose of the charitable trust. As a result, money which was intended to benefit the public has been expended to delay the failure of an uneconomical and costly enterprise.

The role of the Attorney General's Office in discovering these situations and, if appropriate, seeking remedies will be cases of first impression in this state. The court may refuse to apply the higher duty of trustees to the directors of the subsidiary enterprise. If directors are held to a lower standard, many more resources of charitable trusts may be wasted in futile attempts to support enterprises which compete with private business or failing subsidiary corporations. Whether the court finds excessive compensation and mismanagement may hinge on the level of care these directors owe to the public. It is important to note that in both instances the ownership of the for profit enterprises had been approved by the Internal Revenue Service.

In both of the situations cited above, it is apparent that the operation of business enterprises by a non-profit, public benefit corporation has diluted the ability of the charitable trust to serve its intended beneficiaries (the public). Further, through operation of these unrelated business enterprises non-profit entities directly and unfairly compete with investor owned businesses. Unlike other small businesses, these business enterprises have an almost limitless source of funds.

Further, it appears that non-profits are ill suited to operate in a pure business environment. Recently, our office investigated the sale of the Houston Chronicle Newspaper by the Houston Endowment. The Houston Endowment is the largest charitable foundation in Texas and was the owner of the Houston Chronicle newspaper, the largest daily newspaper in Texas. As the Houston Endowment is a private foundation, it was required to divest itself of ownership of the newspaper. When newspaper stories reported that the sale price of the newspaper was significantly less than an amount offered by an unsolicited bidder, our office launched an investigation. The investigation was concluded when the Houston Endowment accepted an offer which effectively raised the price of the newspaper over $30 million.

Had a private, investor owned corporation embarked on the task of selling an asset worth many millions, every bid would have been investigated thoroughly. An unsolicited offer would not have been rejected. Yet, in this case, a non-profit corporation failed to observe its responsibility to the public.

In this situation, the sale of the asset was so significant that it caught the attention of the media. There is no way of knowing how many times such transactions occur without notice to state or federal regulators. Clearly, the lack of accountability has fostered an environment where many charitable trusts are ill equiped to function in fundamentally routine business activities. Volunteer trustees, who are prohibited from receiving personal inurement for their services and serve only part-time, are less likely to apply their full attention to the issues confronting the charitable trust.

There is no way to know the number of private enterprises owned by charitable trusts in the state of Texas. Currently there are no reporting requirements other than the routine articles of incorporation and periodic reports filed with the Texas Secretary of State. In this environment, enumerable abuses most likely occur without the knowledge of either the state attorney general or the Internal Revenue Service. What is worse, it is likely that, absent major reform in state and federal regulation, the situation will only deteriorate.

Some Proposals

In order to effectively regulate charitable trusts, there must be sufficient funding for regulation and an improved system for sharing information between state and federal regulators. Amendments requiring more reporting requirements and imposing penalty taxes will not succeed unless a real threat of enforcement exists. As stated above, state regulators have historically been underfunded. In the state of Texas, the Attorney General attempted to meet the problems of underfunding by supporting legislation requiring certain charitable trusts to pay an annual registration fees. See Exhibit No. 2 in Committee file. In testimony before the Texas House Representatives, Judicial Affairs Committee, the magnitude of the problem was explained. See Exhibit No. 3 in Committee file.

Several charities, including the United Way of Texas, vehemently opposed the passage of the Charities Registration Act. In the end, the Act failed to reach the floor of the Texas House of Representatives for a full vote.

If the states are to effectively regulate charitable trusts within their jurisdiction, sufficient funding must be provided. In order to provide the protection of the public which is so dearly needed, charities must be prepared to pay reasonable sums for their own regulation.

The concept of charities paying for their regulation is not new. Private foundations pay a two percent annual investment excise tax to the federal government. According to the Council of Foundations, the sum total of revenue collected by the IRS from private foundations amounts to over $300 million. The legislative history of the "Tax Reform Act of 1969" reflects that it was the intent of Congress that the money raised through the investment excise tax be used for the purposes of regulating private foundations. In a sense, the investment excise tax would be an audit fee.

In the years since the passage of the Tax Reform Act, it has been quite apparent that the investment excise tax has not been applied to the intended purpose.

To reincorporate the original intent of Congress in enacting the two percent excise investment tax and to foster better supervision of charitable trusts, the authorization of a tax credit, not exceeding twenty-five percent of the federal taxes otherwise due, for fees paid to state government would alleviate the funding problem in each of the states. The tax credit should be available only if the proceeds from the state tax were applied solely to the supervision and regulation of charitable trusts.

By coupling the investment excise tax credit with a requirement that funds be dedicated to the purpose of regulating charitable trusts, states would be encouraged to enact legislation which would require routine reporting of information by charitable trusts and investigations of charitable trusts on a regular basis. Public policy would be served by the enforcement of laws which require charitable trusts to provide some public benefit. Congress may even decide to amend the Tax Code to phase out tax deductions for contributions made to charitable trusts organized in states which do not subject charities to periodic reviews by state officials.

Finally, the Internal Revenue Code should be amended to require the IRS to cooperate and share information with state officials. Too often, resources are wasted through duplication of effort because Internal Revenue Agents are subject to laws which exposed them to criminal penalties if they release information. In the area of charitable trusts, public policy is not served by such a prohibition.

Summary

The attorney generals of various states and the federal government, through the Internal Revenue Service, have a responsbility to the public to protect the assets held by charitable trusts. For too many years, charities have escaped scrutiny and accountability. Only by revising the Internal Revenue Code to encourage improved regulation at the state level will the abuses and misconduct, which are so prevelant in charitable trusts, be reduced.

Public interest and public policy both require that Congress address and reform the Internal Revenue Code so that the bounty of charity will be nurtured and protected.

Sincerely,

Jim Mattox

JIM MATTOX
Texas Attorney General
Post Office Box 12548
Austin, Texas 78711-2548

JM:ops

cc: Honorable J. J. Pickle
763 Federal Building
Austin, Texas 78701

(A:LET4.JRV)

Testimony On Behalf Of

University Patents, Inc.

Before

The Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

On

The Unrelated Business Income Tax

Submitted By F. David Lake, Jr.

July 16, 1987

This written testimony is submitted in response to press release #9, dated May 14, 1987, of the Committee on Ways and Means soliciting testimony with respect to the unrelated business income tax.

University Patents, Inc. proposes that Congress repeal section 1605(c) of the Tax Reform Act of 1986 or amend it as outlined below in order to correct a continuing abuse created by that section.

Background

Technology transfer organizations are companies that assist universities in marketing the products of research they have sponsored. University Patents, Inc. is a small for-profit technology transfer organization located in Westport, Connecticut. It has subsidiaries in Largo, Florida and Urbana, Illinois. University Patents' principal competitors are Research Corporation of Tucson, Arizona, which is organized as a private foundation, and a newly-formed company to which Research Corporation has transferred its technology transfer business (the "technology transfer organization").

Enactment of Section 1605(c)

During conference on the Tax Reform Act of 1986, Research Corporation succeeded in having a provision added to the bill, section 1605(c). This provision allows it to fund a new company which operates as a taxable nonprofit corporation, without being subject to any of the private foundation regulatory taxes or unrelated business income rules that would otherwise apply under the Internal Revenue Code. The provision was not in either the House or the Senate bill and received little or no scrutiny before being added to the Tax Reform Act. It is not a transition rule, as it does not relate to any other provision of the Act, but is a substantive provision applicable to a single company.

Consequences of Section 1605(c)

Section 1605(c) of the Tax Reform Act of 1986 permitted Research Corporation, a private foundation, to transfer its technology transfer business and investment assets, net receivables, and cash not exceeding $35 million to a new taxable nonstock entity for "debt." The transfer was exempted from the private foundation regulatory excise taxes that are designed to safeguard against this type of potentially abusive transaction. Those taxes include the tax against self dealing which normally would prevent a loan of this nature (certainly any loan at a below market rate of interest), the tax on taxable expenditures which normally would prohibit the transfer of assets to an organization that is not exempt and, most importantly, section 507(c) of the IRC which normally would prevent assets being removed from private foundation "solution" without the repayment of tax benefits obtained while the organization was exempt.

The provision in effect allowed Research Corporation to set up a "non-private private foundation" (somewhat analogous to a nonbank bank) -- an organization that is funded with untaxed private foundation dollars yet is beyond the reach of the private foundation regulations. The new entity has a significant competitive advantage over its taxpaying competitors because its multimillion dollar "core capital" was built up without the payment of any income tax. In addition, since the new taxable entity is a nonstock corporation, it does not have to pay dividends like a normal corporation and the "interest" it pays on the so-called debt gives it a deduction for a dividend equivalent. This result does violence to the private foundation and unrelated business taxable income provisions of the Internal Revenue Code.

Possible Solutions

There are two possible solutions to correct the ongoing abuse caused by section 1605(c).

First, section 1605(c) should simply be repealed and the assets of the newly-formed corporation should be required to be returned to Research Corporation where the activities of the technology transfer business once again would be subject to the private foundation regulations and any investment income again would be subject to the 2 percent tax on net investment income under section 4940 of the Internal Revenue Code.

Second, in the absence of repeal, the following technical amendments should be made in an attempt to mitigate the continuing unfairness:

1. The first technical correction would define the term "debt" for purposes of section 1605(c)(2)(A) by requiring that any debt obligation pay interest at least annually at the "applicable federal rate" (as defined in section 7872(f) of the Code) and amortize the principal in substantially level payments (not less frequently than quarterly) over the life of the obligation. It is inconsistent with debt status for the obligation to bear interest at less than a market rate and to be repaid in a balloon payment (which could be rolled over into another long-term obligation) at the end of a long maturity period. It also is inconsistent with the private foundation rules for the transferor private foundation to receive less than a market rate of interest.

2. The second technical correction seeks to cure the potential Clay Brown abuse (a taxable entity sheltering its income with deductible payments that are not taxable income to the recipient exempt organization) by providing that interest paid or payable by the technology transfer organization would not be deductible. This provides a measure of equity with taxpaying competitors which pay nondeductible dividends by, in effect, treating payments by the technology transfer organization to the private foundation as nondeductible constructive dividends. Moreover, the technical correction provides some compensation for the unfair advantage of the technology transfer organization receiving a transfer of a startup fund from an exempt organization that is several times the size it would have been if income taxes had been imposed in accordance with the Code.

3. The third technical change would require the private foundation to treat the interest received as unrelated business taxable income. The circumstances of the creation of the technology transfer corporation as the mirror image of the private foundation indicate that it is de facto a controlled corporation. Moreover, Washington Research Foundation, 50 TCM 1457 (1985), holds that the carrying on of a technology transfer business has a substantial commercial purpose and hence is an unrelated trade or business if carried on by an exempt organization. Thus, the technical amendment would amend section 512(b)(13) of the Code to provide that the technology transfer organization is treated as a controlled organization and the ratio of interest treated as UBTI is 100 percent.

STATEMENT OF U.S. CARTOGRAPHIC INDUSTRY MEMBERS

PRESENTED BY DEAN HAMMOND, PRESIDENT, HAMMOND INC., MAPLEWOOD, N.J.

Mr. Chairman, members of the committee:

Several of the major for-profit companies in the U.S. cartographic industry join together in submitting the following study as written testimony for the committee's hearings on Unrelated Business Income Tax.

The Committee on Ways and Means is conducting hearings to address the issue of favorable tax treatment and other benefits of non-profit organizations, especially with respect to what could fairly be called the for-profit activities of these organizations. The original intention behind the U.S. Government's grant of tax exemption and other benefits to non-profit organizations was to aid in the production of a service or product that could not exist or flourish without such aid.

For over one hundred years, private, tax-paying enterprises have been supplying cartographic materials to domestic and international markets. Within the past thirty years, however, non-profit organizations such as the National Geographic Society as well as not-for-profit organizations such as the American Automobile Association have entered into and absorbed a considerable share of this market. As these non for-profit organizations compete with for-profit cartographic manufacturers, the non for-profit groups apply their tax and/or other benefits to their cartographic operations, giving them an unfair competitive advantage and creating serious economic dislocations in the industry.

American taxpayers, including cartographic manufacturers, have not only in essence subsidized the cartographic sales of these organizations, but have lost the benefit of tax revenues from a once profitable industry. The advantages of non-profit status applied to these activities distort the true economic costs of producing and distributing cartographic materials, cause for-profit manufacturers to lose market share and profit margins, and erode the tax base of a significant U.S. industry.

The cartographic products market can be divided into two primary segments: reference cartographic products and travel cartographic products. The exhibits included in this testimony are from a study conducted by an independent firm that has analyzed the advantages enjoyed by a non-profit institution as a competitor in the reference cartographic industry. The major non-profit supplier in this market segment is the National Geographic Society. A study on the travel cartographic market, whose major not-for-profit competition is the American Automobile Association, is currently underway. The excerpts of the study address the following issues:

- o Historical market share positions of for-profit versus non-profit organizations
- o Differences in marketing costs
- o Differences in cost of capital
- o Comparison of operating statements

Markets

When the National Geographic Society decided in 1957 to compete in the cartographic market, the market was already well-established and competitive. This market entry, albeit related to the Society's original charter, represented an expansion beyond what could be considered integral to this charter. In fact, Melville Bell Grosvenor, the President of the National Geographic Society, who initiated the Society's entry into this market, believed this market to have been untapped, even though for-profit manufacturers had existed with over seventy-five years experience in this industry. After thirty years of participating in this market, the National Geographic now holds a 33% share of the total U.S. market, valued at $90 million. National Geographic sales are in no way limited to their membership.

Benefits of Non-Profit Status

The major benefits associated with non-profit status that are relevant to the cartographic industry include:

- Exemption from corporate income tax
- Exemption from property tax
- Discounted postal rates
- Mailing lists developed on a tax-exempt, subsidized basis

Conclusion

The market invasion of non-profits, operating with significant capital and marketing benefits, has undermined the profit structure of a once profitable and thriving industry. As a result, virtually no taxes are being paid either by the for-profit companies, whose profit margins have been severely eroded by the non-profits, or by the non-profits themselves, who apply their tax exempt status to their operations in the cartographic market.

In submitting this statement to your committee, the U.S. for-profit manufacturers of cartographic products hope to bring about fair competition in our industry. To this end, we would like to suggest several actions for your consideration:

1) Make available non-profit status to the for-profit cartographic companies.

2) Spin off the cartographic operations of non-profit organizations into separate, for-profit, tax-paying businesses.

3) Revoke both tax and non-tax benefits from the cartographic operations of non-profit organizations.

4) Require non-profit organizations to purchase all cartographic materials from for-profit suppliers; make the non-profit organization's customer list available to others; and allow for-profit suppliers to advertise in the magazines of the non-profit organizations.

Thank you for this opportunity to express the views of the cartographic industry to your committee.

Respectfully yours,

Dean Hammond
President
Hammond Incorporated

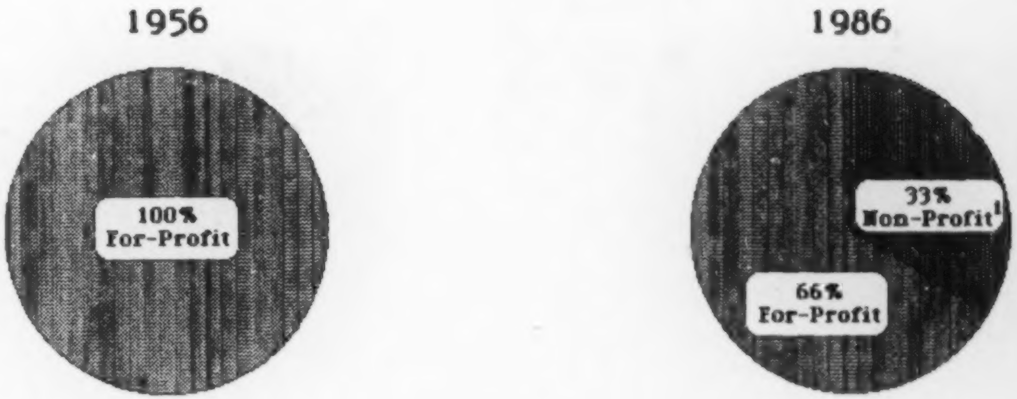
EXHIBITS

1. Historical Market Share
2. Direct Response Marketing Costs
3. Rate of Capital Accumulation
4. Comparative Operating Statements

EXHIBIT 1

REFERENCE CARTOGRAPHIC INDUSTRY

Historical Market Share



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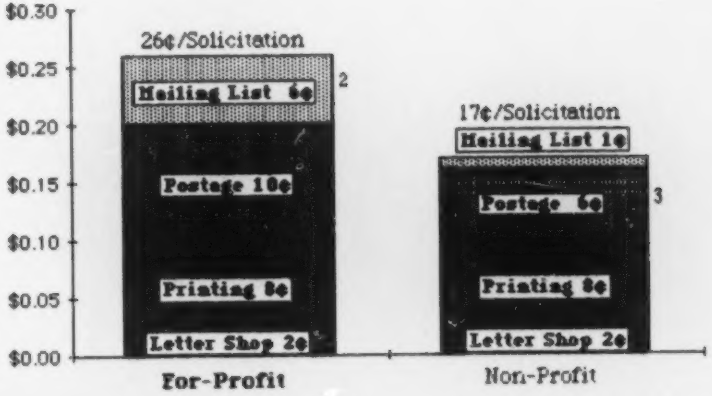
[1] The National Geographic Society

EXHIBIT 2

REFERENCE CARTOGRAPHIC INDUSTRY

Direct Response Marketing Cost[1]



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[1] Based on a direct mail channel of distribution.

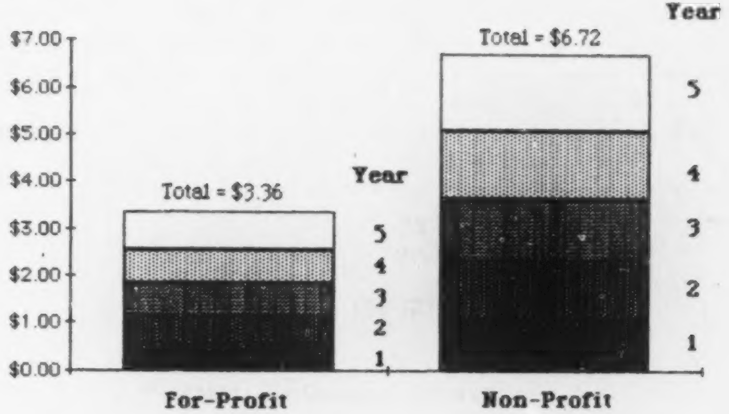
[2] For-profit must rent buyer list and non-profit uses primarily their membership list. Non-Profit membership list has been created and sustained due in large part to their subsidized status.

[3] Postal rates are discounted bulkrate average for a similar mailing.

EXHIBIT 3

REFERENCE CARTOGRAPHIC INDUSTRY

Rate of Capital Accumulation[1]



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[1] Assume equal and constant earnings of $1 per year, interest rate of 10% compounded annually, and 50% tax rate.

EXHIBIT 4

REFERENCE CARTOGRAPHIC INDUSTRY

Comparative Operating Statements[1]

	For-Profit	Non-Profit
Net Sales	100%	100%
Cost of Sales	22	22
Gross Margin	78	78
Operating Expense		
Editorial and Production	15	15
Marketing[2]	39	30
Fulfillment (net)	6	6
General & Administration	13	13
Total Operating Expense	73	64
Interest and Property Tax[3]	4	2
	-------	-------
Net Income	1%	12%

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[1] Assumes direct response marketing channel of distribution.

[2] Marketing subsidy of 9% is divided between postage and mailing list expense.

[3] Capital costs are discounted at 50% due to tax-exempt status and absence of property tax.

COMMENTS OF
ROBERT G. EANEMAN, CHAIRMAN
VOLUNTEER TRUSTEES OF NOT-FOR-PROFIT HOSPITALS

July 6, 1987

The Honorable J.J. Pickle
242 Cannon House Office Building
Washington, DC 20515

Dear Congressman Pickle:

On behalf of trustees of not-for-profit hospitals across the country, Volunteer Trustees is pleased to submit the following comments on the unrelated business income tax Hearing for the record. We were disappointed that you were absent during the testimony of the hospital panel and the subsequent exchange. This letter addresses three specific issues raised at the Hearings.

The Presumption of Wrongdoing by Tax-Exempt Organizations

Continuous confusion over the number of organizations required to file 990 and 990T forms was a serious problem for two reasons. First and most obviously it pointed up the lack of good data available. Secondly, it fed a presumption of wrongdoing by the not-for-profit organizations-- a presumption that permeated the Hearings.

Hospitals are a small percentage (6%) of total not-for-profit organizations required to file 990s and with proper data may in fact be shown to be disproportionately represented in those filing 990T forms. As the testimony of the hospital community indicated, we encourage improved information collection and dissemination. We also support increased enforcement if that data indicates need for it. We see no justification to conclude now that hospitals are abusing a privilege or cheating the government.

Understanding Hospital Services and Related Activity

It is impossible to assess the issue of relatedness without an accurate understanding of the essential activity of the hospital itself. Hospitals are not four walls with beds. Hospitals are a broad spectrum of services, some delivered in an institutional setting and some not; some delivered bedside, most not. Understanding the hospital as a community-owned, community-responsive organization of services, it is then quite a different question to ask if home health care services, heraring aid or ambulance services are "related" to the tax-exempt purpose of the hospital. In fact, it would be contrary to that purpose for hospitals to limit their services to acute inpatient care. The courts have repeatedly confirmed the obligation of the hospital to respond to the broader needs of the patient.

Balancing Concern for Small Business with Benefits to the Patient

The narrow view of the hospital was most evident during the testimony of the small business panel. The Committee seemed unwilling to look at the issue from any perspective other than that of small business. At no time during the exchange did the Members raise the question of benefits to community or to patient-- the very reason for creating a tax exempt sector in the first place.

The Hearing Aid Association provided startling testimony in this regard. They reported a 350% mark up of their products (from $200 cost to $898 retail) and complained that they were suffering "unfair" competition from the not-for-profit hospitals selling for less! Why is it not reasonable to note that hospitals reduce costs to the consumer or to raise questions about who benefits from such competition and what benefits accrue to the community in reduced health care costs? Why was it out of bounds for the Committee to ask if the not-for-profit sector is a good use of tax dollars foregone?

The Future of the Not-For-Profit Hospital

No remarks made during the health care testimony were more relevant to the future of the not-for-profit hospital sector than those of Bradford Gray, Ph.D., author of the Institute of Medicine's study For-profit Enterprise in Health Care. He is uniquely qualified to contribute to the Committee's understanding of this important issue and made two points essential to fair evaluation.

First, he pointed out that not-for-profit hospitals afford two major societal advantages. They assure stability in the community by not being subject to the imperative of maximizing return to owners invested in equity capital; and, they "behave in ways that depart from strict pursuit of economic incentives." He cites as examples:

uncompensated care --- 75% of such services are provided by the private not-for-profit sector;

unprofitable, but needed care --- neonatal units, burn centers, 24-hour emergency rooms, obstetrics, and most other tertiary care services predominate overwhelmingly in the not-for-profit sector;

research and educational activities are almost entirely in the not-for-profit sector;

Areas of poor economic return are served by not-for-profit hospitals while for-profit hospitals concentrate in areas which are non-regulated and where the population is growing;

lower mark-up and lower charges are consistent findings in not-for-profit hospitals as compared to for-profit.

Secondly, Dr. Gray noted that not-for-profit hospitals face an immediate financial dilemma. With Medicare and other third-party payors reducing reimbursement, hospitals must find new ways to support those needed but unprofitable services once financed by excess revenues or "profits." They can "cannabalize" their assets thereby robbing future generations, or they can develop new sources of income. Gray concludes:

> "Hospitals' ability to engage in socially important non-renumerative activities in the future will depend on their ability to generate income from sources other than patient care.... Public policy should be concerned with encouraging and facilitating such activities by hospitals, not with inhibiting their ability to engage in them."

As trustees we are stunningly aware of the impending economic constraints. But as businessmen and women we are also aware of the benefits which our communities derive directly and indirectly from our not-for-profit organizations. We are focused not on the preservation of a particular institution, be it hospital, museum or family service agency, but on the survival of a concept that we know is working.

We are greatly concerned that the Committee is giving short shrift to the strengths of the not-for-profit sector. You ask for legislative recommendations implying that there is abuse that needs correcting. If it is true, let us document the abuses and correct them.

But be wary. The alternative to not-for-profit is government and the public hospital, not small business. Neither small businesses nor large hospital corporations, for that matter, are interested in competing it comes to paying for the education and training of the next generation of doctors, supporting the trial and testing of new technologies, providing the non-lucrative tertiary services which we have all come to expect, or to caring for the poor in our communities. These are not profitable.

We hope the Committee will look responsibly to public policy incentives. The availability of health care services should be determined by community need, not by profitability and the accompanying measure of return-on-investment. Tax policy needs to buttress, not cripple, the tax-exempt sector. The important question for the Committee---and the nation--- is can our hospitals survive, not should they.

Sincerely,

Bob Eaneman

Robert G. Eaneman, Chairman

BOB WISE
3D DISTRICT, WEST VIRGINIA

COMMITTEES
PUBLIC WORKS AND TRANSPORTATION
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House of Representatives
Washington, DC 20515

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April 2, 1987

The Honorable J. J. Pickle
Chairman
Ways and Means Subcommittee on Oversight
1105 Longworth Building
Washington, DC 20515

Dear Chairman Pickle:

We have recently been made aware that the Subcommittee on Oversight has been conducting hearings on non-profit organizations and their tax-exempt status. We have both been involved in this issue for some time now, especially in regard to organizations that target the elderly through direct mail solicitation, and would like to relate to you our experience in this area.

There are a number of organizations that have received attention and criticism for their actions. While we are aware of many of these groups and have seen copies of their mailings, the organization we have been most concerned with is James Roosevelt's National Committee to Preserve Social Security and Medicare. The National Committee, through its operations and tactics, has pointed out to us a number of problems with the regulation of non-profit groups and the privileges they enjoy.

Of course, the most important and substantial of these privileges is their tax-exempt status. This status provides non-profit organizations a great boon in terms of both finances and prestige. Tax-exempt status is not difficult to achieve as the hundreds of thousands of such groups indicates. With the granting of tax-exempt status, organizations are expected to operate within the public interest. But who defines this interest and what are the penalties for abusing this privilege? The Internal Revenue Service indicates that there is no procedure to review complaints on a given organization and to decide if it is truly operating within the public interest.

Representatives of your Subcommittee staff have indicated that you may soon hold hearings on the financial disclosure information that is required on the 990 forms that non-profit organizations must file. We have concerns that these forms do not adequately require groups to reveal their true fundraising expenses. This problem can be partially explained by the accounting methods that some non-profits use, but stricter requirements could change this situation.

In testimony before the House Aging Committee on February 4, 1987, David Ormstedt, Assistant Attorney General for the State of Connecticut, gives an example of this problem. He uses the simple case of a two page direct mail package. The first sheet contains a description of a particular social welfare problem and why something needs to be done about it. The description consumes eighty percent of the available space. The remaining twenty percent requests a donation to enable the organization to solve the problem. The petition contains no requests for funds. Generally accepted accounting

The Honorable J. J. Pickle
April 2, 1987
Page Two

principles allows this organization to allocate ninety percent of the cost associated with this mailing (printing, postage, paper, mailing list, graphics, design, etc...) to the program service function and only ten percent to the fundraising function, because the request for funds consumed only one-tenth of the combined surface area of the two sheets of paper. This is so, even though the mailing list was selected solely for its fundraising potential and the organization would not have mailed the petition without the accompanying request for money.

This problem which Mr. Ormstedt's points out is carried over to the 990 forms. Once again, lets use the National Committee, which uses these accounting principles, as an example. In the 990 form that the National Committee filed for 1985, they list revenues of $29.5 million with expenses of $24.6 million. Of the money they spent, $3.8 million or 15 percent is listed as fundraising expenses. When you look at direct mail expenses (printing, publication, postage and shipping), however, a different story emerges. Of the $24.6 million spent, $21.6 million falls into those catagories. While not all of the National Committee's mailings are solicitations, the majority of them fall into this category. If you assume that these mailings would not have been sent without the request for funds included, the National Committee's actual fundraising costs are in excess of fifty percent of their revenues.

It is our strong feeling that the public needs to be made aware of this information and to that end we have introduced legislation which would require non-profit organizations to disclose additional financial information. This legislation, which is modeled after provisions already on the books in 31 states, would require groups to disclose the names of individuals (or firms) who are conducting their fundraising, the gross amount raised by such persons, the compensation they receive, and a description of their activities. This information would be added to the 990 forms and should not create any additional burdens for non-profits because, as we mentioned previously, this information is already required by a majority of states. Since these disclosure requirements would be added to the 990 forms, organizations that are currently exempt from filing these forms, would not be subject to these provisions.

We appreciate the opportunity to convey our views to you and are grateful for your interest in this area. If either of us can provide you or your staff with additional information, please let us know. For our part, we would appreciate being kept appraised of your Subcommittee's activity in regard to non-profit organizations. We thank you for your time.

Very truly yours,

Sherwood Boehlert
Member of Congress

Bob Wise
Member of Congress

BOB WISE
3D DISTRICT, WEST VIRGINIA

COMMITTEES:
PUBLIC WORKS AND TRANSPORTATION
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July 16, 1987

The Honorable J. J. Pickle
Chairman
Ways and Means Subcommittee on Oversight
1105 Longworth Building
Washington, DC 20515

Dear Mr. Chairman:

We are both grateful to you for your continuous and comprehensive hearings on non-profit organizations. These hearings are providing important information on the operations and practices of non-profit groups.

As we laid out for you in our letter of April 4, 1987, our main concern in this area is that non-profit organizations do not deceive the public with false claims and that the complete financial records of non-profits be accurate and available to the public. To that end, we introduced H.R. 1566, which would require additional financial disclosure by non-profit groups on the 990 forms which are filed with the Internal Revenue Service. We are hopeful that such a proposal, if enacted, would provide a more accurate view of an organization's fund raising activities than the 990 forms currently provide.

We are appreciative of your offer to include our proposal, where you deem it appropriate, in your recommendations to the full Committee. Additionally, both of us would be more than willing to work with you if you desire to hold a hearing on this important issue.

Very truly yours,

Sherwood Boehlert
Member of Congress

Bob Wise
Member of Congress

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July 15, 1987

Robert J. Leonard, Chief Counsel
Committee on Ways and Means
U. S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

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Winterset, IA 50273
1-800-233-4327

Re: Abuses of Tax-Exempt Status by "Nonprofits" Involved in Commercial Activities

Dear Chief Counsel Leonard

The licensed hearing aid dealers in central Iowa have a new competitor - the United Way of Central Iowa. $160,000 of money collected in the name of charity will be given this year to the Des Moines Hearing & Speech Center, a United Way Agency.

Yes, this same agency recently started a "For Profit" hearing aid business and they are soliciting the same clients that the audiologists and hearing aid dealers in our community are competing for. The only difference is the Des Moines Hearing & Speech Center will not pay any income tax this year and money and equipment given to them for their commercial enterprise will be considered tax deductible. We will pay taxes and contributions made to our firm would not be considered tax deductible. Yes, they are actively seeking the millionaire clients and on several occasions in the past year they have turned down persons referred to them for hearing aid assistance because they did not have funds to purchase hearing aids.

Tax laws must be changed to 1) prohibit any organization from escaping the payment of taxes when they establish commercial businesses and 2) prohibit the deductibility of contributions given to the United Way of Central Iowa and other similar organizations when the money is used for commercial business activities.

Thank you for the opportunity present these facts. Those of us who represent small business in America need your help.

Thank you,

Paul E. Woodard
Elected Delegate, 1986 White House Conference on Small Business
Chairman, Small Business Committee, Iowa Association of Business & Industry
Guardian, National Federation of Independent Business

Paul E. Woodard
Director, Hearing Aid Services

Leslie A. Whippen, M.S. CCC
Director, Audiology Services

Susan E. Schmiechen, M.A. CCC
Audiologist

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(Continued Next Page)

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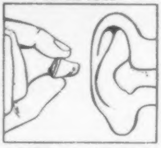

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June 12, 1987

The Honorable J. J. Pickle, Chairman
%Robert J. Leonard, Chief Counsel
Ways & Means Committee
U. S. House of Representatives
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Chairman Pickle,

As a small businessman (which I believe is composed of the larger majority of the people in free enterprise) we have seen abuse of the so called tax exempt and non-profit institution competing with the tax paying businessman. I am happy to see results of the White House Conference on Small Business now bringing forth results. It is not fair for my tax money to be taken and given to either an organization or institution that will then turn around and compete with me unfairly as they have their operating costs paid by my taxes. I have to pay rent, utilities, etc. in addition to costs of the hearing aid. These costs all have to be added to the cost of the item I am selling. If all expenses including salary was given me, I could then compete with these non-profit institutions.

Thanking you in advance for your time and energy spent in researching this unfair practice.

Yours truly,

G. Charles Young

G. Charles Young
GCY/mah